INTERNATIONAL MONETARY FUND

IMF POLICY PAPER

PROGRAM DESIGN IN CURRENCY UNIONS

March 2018

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 21, 2018 consideration of the staff report.
- The **Staff Report**, prepared by IMF staff and completed on August 29, 2017 for the Executive Board's consideration on February 21, 2018.
- **Staff Supplements**

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IMF Executive Board Discusses Program Design in Currency Unions

On February 21, 2018, the Executive Board of the International Monetary Fund (IMF) discussed general guidance on the design of Fund-supported programs with members of the existing four currency unions—the Central African Economic and Monetary Community, the Eastern Caribbean Currency Union, the European Monetary Union, and the West African Economic and Monetary Union.

The IMF has an extensive history of program engagement with members of these currency unions, but has never developed general guidance on the design of IMF-supported programs with the individual members of these unions. This lack of guidance stands in contrast with the approach to macroeconomic surveillance, where the Fund has provided guidance framing the discussion of policies that have been delegated by national authorities to the institutions of the currency union.

A staff paper entitled *Program Design in Currency Unions*, together with a set of supplemental papers, served as the basis for the Executive Board's consideration of new guidance aimed at providing greater clarity on the design of programs with members of currency unions. These clarifications also address recommendations of the Fund's Independent Evaluation Office, which sought to clarify how policies delegated to union-level institutions are incorporated into Fund-supported program. These papers, and the Board's discussion, also complement recent work related to IMF financial support in the context of Regional Financing Arrangements. This latter work was discussed by the Board in July 2017.

Executive Board Assessment[1]

Executive Directors welcomed the opportunity to discuss proposals with regard to program design for members of currency unions within the Fund's lending framework. Consistent with the approach taken in the Integrated Surveillance Decision, which recognizes the important role that currency union institutions play in Fund surveillance, Directors supported establishing general guidance on Fund engagement with currency union institutions in circumstances where the policies of these institutions are critical to the success of Fund-supported programs. They noted that this would help ensure that safeguards for

[1] An explanation of any qualifiers used in summing ups can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

program success and the use of Fund resources are applied in a consistent and evenhanded manner.

Directors agreed that the design of Fund-supported programs for the members of currency unions should account for how the nature of the currency union affects the member's balance of payments need, and ensure that there is sufficient adjustment to resolve the member's balance of payments problem within the period of the program. In this regard, they noted that in currency unions with a fixed exchange rate, there may be an inherent interconnection between the external viability of the union and the external stability of the members of the union. They took note of the fact that certain monetary policy operations by currency union central banks may impact their members' balance of payments. Most Directors supported staff's proposal to follow a consistent framework in measuring the balance of payments need of currency union members in the future, while a number of Directors emphasized that the proposed approach should take into account the specific features of the respective currency unions.

Directors emphasized that the Fund has not only the authority, but also the obligation to implement policies on the use of its resources in order to assist members to solve their balance of payments problems and to provide adequate safeguards to Fund resources. Under this obligation, when policies under the purview of union-level institutions have been necessary to a member's program implementation, these have been incorporated into Fund-supported programs in an ad hoc way. Accordingly, a number of Directors saw merit in extending the scope of the Guidelines on Conditionality to encompass actions by union-level institutions, on grounds of consistency and evenhandedness. Most Directors believed that separate guidance should apply to assurances from union-level bodies, when needed, in recognition of the fact that decision-making by union-level institutions generally involves all currency union members, and not only the borrowing member. In the spirit of consensus, Directors endorsed staff's proposal to formalize current practices, with the modalities and operational aspects as outlined below.

Directors underscored that program design should be based, to the extent possible, on policies over which the national authorities of the member have direct or indirect control. They agreed that, insofar as currency union members have delegated important economic and financial policies to union-level institutions, assurances with respect to actions by these institutions would be sought when the member's adjustment policies alone could not meet the program's objectives. The scope of such actions would normally be limited to the specific member country, mindful of the need to mitigate their potential impact on the rest of the currency union. The threshold for the Fund to make the use of its resources conditional on a policy action by a union-level institution is the same as for policies under the member's own control: the measure must be deemed critical to program success. Directors recognized that criticality is a judgment call, although a number of them sought greater clarity on its scope in the context of Fund-supported programs for currency-union members. A few Directors saw value in considering cost efficiency alongside criticality, and assessing whether union-level actions can achieve the program's objectives at a lower cost, within the mandates of union-level institutions.

Directors recognized that, in very exceptional cases, the Fund may need to seek assurances regarding adjustments in union-wide policy settings that affect other members of the currency union. These exceptional circumstances could occur when policies at the union level, such as unsustainable foreign exchange interventions, have contributed to the balance of payments problem facing the union's members, or when a critical mass of the union's members face a contemporaneous balance of payments problem.

Noting that legal, institutional, and policy frameworks differ across currency unions, Directors stressed that such differences need to be taken into account, on a case-by-case basis, in the design of programs with members of currency unions. In exercising this flexibility, the Fund would be evenhanded in its treatment of members in different currency unions, as well as in relation to the rest of the Fund's membership.

Directors concurred that, consistent with the approach taken in all programs with member countries, the Fund will not seek policy assurances from a union-level institution that would involve it taking actions that are inconsistent with that institution's mandate and legal and institutional frameworks. They acknowledged that, when an institution provides policy assurances, it does so voluntarily and in accordance with its own assessment of what policies are appropriate. Consequently, the provision of such assurances would not intend to intrude, and should not be construed as intruding, on the independent authority of the institution concerned. In the event that an institution is prevented by its mandate or legal and institutional frameworks from providing the assurances being sought, Directors agreed that the Fund will make every effort to work with the borrowing member to adapt the program design in such a way that its objectives can be met with an alternative policy mix.

Directors agreed that assurances over critical policy actions need to be clear, specific, monitorable and—where necessary—timebound. Policy assurances must be appropriate, taking into account the nature of the specific policy action in question. They would be provided in writing, in the form of a letter from the relevant union-level institution to the Managing Director, or a published statement by the union-level institution. In a narrow set of circumstances—those identical to conditions established under existing policies—the assurance could be provided in a confidential form. Directors noted that confidential side letters could be used only when the conditions of the side letter policy are met. In highly exceptional circumstances, oral understandings could be accepted to complement written assurances, although measures judged critical to a member's program must be provided in writing.

Directors emphasized that the measures for which assurances have been sought must be critical to the success of the member's program. In the event that such a measure is not fully implemented, a decision by the Executive Board to approve the use of Fund resources by the member would be contingent on a finding that the objectives of the member's program can nevertheless be met. Such a finding would be based on staff's assessment that the shortfall in policy implementation is minor or temporary, or that sufficient corrective action has been taken.

Directors highlighted the merits of early engagement with relevant currency union institutions when assurances are likely to be sought from them. The assurances will normally be obtained by the time Fund staff submits the documents for interdepartmental review, and in line with the practice on prior actions, the communication conveying these assurances from the currency union institution should be made available to the Executive Board no later than five working days before the Board meets to discuss the use of Fund resources by the member, but in any event no later than the time of the Board meeting. The written communications will be part of the program documentation, and published following a similar approach to the one that applies to the publication of policy intention documents from the national authorities.

Directors emphasized that the Board should be regularly updated on the status and implementation of previously agreed understandings with currency union institutions, and of any proposed amended or new understanding. Such assessments are expected at the time of each review. When programs with several countries rely on a shared set of policy assurances, these assessments could refer to other recent Board assessments, where relevant, provided that the assurances are assessed at least semi-annually, and the Board considers proposed new or amended assurances at the earliest relevant juncture.

Directors expected that the staff report for the member’s program provides a clear explanation as to why the resolution of the member’s balance of payments need cannot be achieved solely with domestic policies and why the union-level assurance is critical for program success. They stressed the need for the Board to express its view on the criticality of these assurances, which would be reflected in both the summing up and the Chairman’s statement.

Directors concurred that staff background papers on a union-wide situation could be useful, especially where—such as in the case of a union-wide shock or inadequate union level reserves—adjustment in several currency union members is required, or where the measures under consideration potentially create spillovers or have a union-wide impact. They expected staff to exercise judgment in determining when such a report is necessary, although when several countries in a union have concurrent Fund-supported programs and union-level actions are critical, one union-wide background paper within a six-month period would likely suffice.

This guidance shall take effect immediately, or from the next program review in the case of current arrangements.

INTERNATIONAL MONETARY FUND

PROGRAM DESIGN IN CURRENCY UNIONS

August 28, 2017

EXECUTIVE SUMMARY

Despite a long history of program engagement, the Fund has not developed guidance on program design in members of currency unions. The Fund has engaged with members of the four currency unions—the Central African Economic and Monetary Community, the Eastern Caribbean Currency Union, the European Monetary Union, and the West African Economic and Monetary Union—under Fund-supported programs. In some cases, union-wide institutions supported their members in undertaking adjustment under Fund-supported programs. As such, several programs incorporated—on an *ad hoc* basis—critical policy actions that union members had delegated. *Providing general guidance on program design for members in a currency union context would fill a gap in Fund policy and help ensure consistent, transparent, and evenhanded treatment across Fund-supported programs*.

This paper considers two options on when and how the Fund should seek policy assurances from union-level institutions in programs of currency union members. Option 1 would involve amending the Conditionality Guidelines, which would allow the use of standard conditionality tools with respect to actions by union-level institutions. Option 2—which staff prefers—proposes formalizing current practices and providing general guidance regarding principles and modalities on policy assurances from union-level institutions in support of members' adjustment programs. Neither option would infringe upon the independence (or legally-provided autonomy) of union-level institutions, since the institutions would decide what measures or policy actions to take—just as any independent central bank or monetary authority does, for example, in non-CU members.

The paper discusses several implementation issues for Option 2. First, programs should remain member-focused, i.e. organized to the extent possible around policies under the purview of members' national authorities (*henceforth*: national policies). Assurances regarding union-level policy actions would be sought only when they are *macro-critical*, and actions to be undertaken by members' national authorities (*henceforth*: national actions) are insufficient to ensure the success of a Fund-supported program. Past experience suggests that union-level actions are likely to be country-specific and union-wide measures are expected to be rarely used. Second, as is the case for program conditionality relating to national policies, policy assurances should be under the control and respective mandates of the relevant union-level institutions and they should be provided voluntarily, and in a *clear, specific, monitorable, and time-*

bound way. Third, there would be some flexibility over how policy assurances would be conveyed. While they would typically be conveyed *publicly in writing*, in well-defined exceptional circumstances, assurances could be provided confidentially.

The paper also elaborates on other operational aspects, including: (i) modalities regarding assurance updates; and (ii) the discussion of assurances in staff reports and program documents, and how their endorsement by the Executive Board would be formalized.

Approved By

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CONTENTS

INTRODUCTION 5

NATURE OF CURRENCY UNIONS 7

THE NATURE OF BALANCE OF PAYMENTS NEEDS IN CURRENCY UNIONS 10

THE FUND'S LEGAL FRAMEWORK FOR ITS FINANCING OPERATIONS 14

OPTIONS: POLICY ASSURANCES AND IMPLEMENTATION ISSUES 15

A. Options for Articulating Policy Assurances 15

B. Criticality for Program Success 17

C. Implementation Modalities for Option 2 19

D. Operational Aspects 22

ISSUES FOR DISCUSSION 24

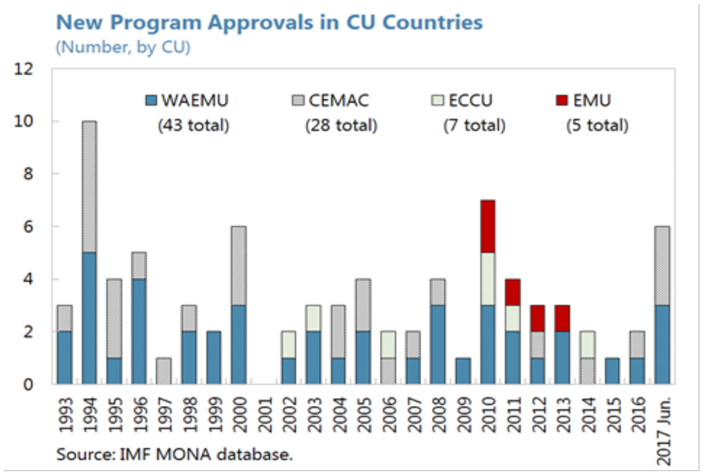
BOXES

1. Programs with CU Members—Lessons from Recent Ex Post Evaluations 25
3. Experience with Policy Assurances from Union-Level Institutions 26
4. Banking Oversight Issues in Europe’s Banking Union 28
5. Program Design and Conditionality 29
6. Program Adjustment and Objectives 32

References 33

INTRODUCTION

1. **The Fund has a long history of program engagement with members of currency unions** (CUs).[1] It has now engaged with members of all four of the CUs under Fund-supported programs, through PRGT or GRA arrangements and outright purchases or disbursements. While Fund financing operations are member-based, in several of these programs, the Fund has sought—and incorporated in programs—critical policy actions under the control of union-level institutions. Despite this, there is currently no general guidance on program design in CUs, including when important policy areas that may be critical for program success are delegated to CU institutions.[2]


New Program Approvals in CU Countries
(Number, by CU)

Source: IMF MONA database.

2. **This contrasts with the area of surveillance, where the Fund has developed guidance to frame discussions on policies that have been delegated to union-level institutions.**[3] With CU members delegating key policies to union-level institutions, there was a recognition that an evenhanded treatment of these countries also required surveillance at the union level. Starting in 2002, the Fund adopted a series of decisions that established modalities for discussing policies delegated to the union level with union-level institutions in a surveillance context. Further, the 2007 Surveillance Decision, and subsequently, the Integrated Surveillance Decision (ISD), clarified that members of currency unions remain subject to all their obligations under Article IV, Section 1. Accordingly, each member is accountable for those policies that are conducted by union-level institutions on its behalf. The ISD also clarified the Fund's role in assessing union-level policies when such an assessment is necessary to allow the Fund to fulfill its surveillance mandate with respect to

[1] The Fund's membership includes several countries who are also members of one of the four currency unions: the West African Economic and Monetary Union (WAEMU), the Central African Economic and Monetary Community (CEMAC), the Eastern Caribbean Currency Union (ECCU), and the Euro Area (EMU). While the EMU's currency, the euro, is a free float, the other three currency unions operate a fixed exchange rate regime. Since the Fund is a member-based institution, its financing relationship is with its members, and the Fund is unable to lend to a currency union institution.

[2] IEO (2016) "The implications of this split [of policy responsibilities within a currency union] for the conduct of Article IV consultations are explicitly considered in the various IMF surveillance decisions and corresponding guidance notes to staff. But the 2002 Conditionality Guidelines (IMF, 2002b) and the Revised Operational Guidance Note to IMF Staff (IMF, 2014a) do not explain how IMF-supported programs will approach the split of policy responsibilities in a currency union from the standpoints of program design and conditionality."

[3] This is mainly accomplished by holding regular discussions with regional CU institutions that then become part of the bilateral consultations with the members of the union. This practice now takes place with all CUs. As a general matter, surveillance over members of currency unions assesses whether policies implemented at the level of the union and at the level of the member are promoting the balance of payments and domestic stability of the union.

individual CU members. Establishing guidance over program design issues specific to currency union members would thus fill a gap in Fund policy—akin to that previously identified in surveillance policy—and help ensure consistent, transparent, and evenhanded treatment across Fund-supported programs. Given the above, the premise of the paper is that maintaining the status quo is not a viable option.

3. **Previous studies have flagged the need to clarify program design issues for members of currency unions.** Specifically, the IEO evaluation on euro area programs recommended "[t]he IMF should clarify how guidelines on program design apply to currency union members." The 2015 *Crisis Program Review* found "where changes in currency-union-wide policies are important for program success, the Fund should provide advice through its surveillance as warranted or, when necessary … seek commitments on prospective implementation of necessary union-wide policies."[4] Recent Ex Post Evaluations of large programs with currency union members have also noted the importance of union-level policies (see Box 1). This paper forms a key part of Management's response to the IEO's recommendation, as well as to the findings of these other reports. It also complements a separate work stream that considers issues related to IMF financing in the context of Regional Financing Arrangements.[5]

4. **This Board paper focuses on the nature of the balance of payments need faced by CU members as well as on the role union-level policies can play in supporting the member's adjustment program**. Program design entails many elements, including: assessing the type of the balance of payments problem and the size of the financing need (against which Fund financing can be provided); identifying a path of adjustment effort along with sources of financing; and designing conditionality to support the required adjustment and to provide safeguards to Fund resources. While many aspects of program design are the same for members of currency unions as for other types of economies, two important aspects differ:

- The first is the nature of the balance of payments need in countries that share a currency and a central bank with others.[6] Despite sharing a common currency, these countries can still suffer their own individual balance of payments need (and crisis)—e.g. due to inadequate reserves, capital flight by residents, or a sudden stop by external investors.

- The second is the role policy actions that are under the control of currency union institutions can play in securing adjustment. While the focus in program design should remain on

[4] Directors largely agreed, noting that "where changes in currency union-wide policies are important for program success, the Fund should provide advice through surveillance as warranted. Some Directors considered that the Fund could also seek commitments on union-wide policies if necessary for program success or financing assurances" (BUFF/15/111).

[5] Collaboration Between Regional Financing Arrangements and the IMF.

[6] The unilateral adoption of a foreign currency as the legal tender, under full dollarization or full euroization, is distinct from currency union membership in that there is no currency union central bank that manages pooled reserves. Moreover, in dollarized or euroized economies, other policy responsibilities typically remain with domestic (national) institutions.

policies under the control of the national authorities, these may not always be sufficient to achieve the program objectives. Since members of currency unions delegate certain policies to union-level institutions, not all policies can be implemented by the member itself through its own national authorities. Nevertheless, actions in such delegated policy areas may be necessary to restore medium-term external viability.[7] The approach taken in this paper is evolutionary rather than revolutionary in that our preferred way forward is to codify past practice and formalize the policy support that union-level institutions often give to their members undertaking adjustment programs.

5. **The paper proceeds as follows**: The second and third sections clarify the nature of currency unions and the balance of payments needs in their members. The fourth section highlights relevant aspects of the Fund's legal framework relating to the use of its resources, while the fifth section provides some guidance on when and how the Fund should seek assurances from union-level bodies in programs of currency union members. Two options are considered. Option 1 would entail bringing policy actions by union-level institutions into the scope of the Conditionality Guidelines. Option 2, which staff prefers, proposes establishing general guidelines on policy assurances from union-level institutions. Finally, the sixth section concludes with some issues for discussion.

NATURE OF CURRENCY UNIONS

6. **CU membership entails the delegation of monetary and exchange rate policy to union-level institutions, though delegation can cover other policy areas as well**. By becoming a member of a CU, members adopt a single currency issued by the CU central bank, which conducts monetary policy for the union. With few exceptions, capital flows freely within the currency union.[8] Currency union members may also delegate other policy areas, such as aspects of fiscal or banking sector policies, to union-level bodies. While allowing the country to enjoy the benefits of currency union membership, this delegation may limit the policy adjustment options open to national authorities when a country has imbalances or is hit by a shock. In addition, all CUs have moved towards some form of regional integration, with all four CUs either part of a customs union (albeit with some restrictions) or operating within a common market (the case of the EMU within the EU).[9]

7. **In the context of this paper, union-level institutions principally refer to entities responsible for implementing policies delegated to the union**. Union-level institutions share two key characteristics: (i) they have a mandate for, and control over, the policy area that is (at least partly) delegated by CU members; and (ii) they are able to take actions under their own authority.

[7] For instance, if a banking crisis were at the core of a country's balance of payments problems—with banking sector oversight now delegated to union-level institutions to varying degrees in all four CUs—program success may require policy actions to be implemented at the union level to resolve the member's balance of payments problem, including to restore financial stability and thus achieve medium-term external viability.

[8] The most notable exceptions are those related to the exchange restrictions that some euro area members imposed during the euro area crisis.

[9] See first Background Note.

Examples of CU institutions include the CU central bank, and entities responsible for CU banking sector oversight and resolution. However, the category of union-level institution may extend to entities that are responsible for a broader set of policies delegated by CU members (including where these entities are governed by a broader set of countries). For instance, issues of competition policy and fiscal policy convergence in the EMU are overseen by institutions of the broader European Union, while development lending issues in the African monetary unions are handled by regional development banks in which non-CU countries may participate.

8. Currency unions are quite heterogeneous. While monetary and exchange rate policies are delegated in all unions, the nature of these policies differs substantially. The euro area has adopted an inflation objective and has a fully floating currency, while the other three unions all have currency pegs, with the union central bank managing pooled reserves. Another distinction arises from the fact that the euro is a reserve currency, which means that there is limited need to hold reserves at the union level. Currency unions also differ in structural terms: the EMU is a "*decentralized"*[10] union (where monetary policy is set at the union-level central bank, the ECB, but there is also a national central bank in each member which carries a separate balance sheet[11] and has some leeway in providing liquidity assistance in emergency cases subject to the control by the union level), while the other unions are "*centralized"* (with only a union-level central bank which manages the union's monetary and exchange rate policy, and which can have representative branches in individual members to implement some transactions). Economic and financial integration among CU members—and hence intra-union spillover risks—also differs substantially.

9. The literature on currency unions has long debated the importance of having in place elements of an optimal currency area (OCA) and of a banking union (IMF 2013).[12] These factors help facilitate the conduct of common monetary policy in the absence of intra-CU currency flexibility. The banking union is especially important when the size of the financial sector is large enough to skew national incentives and/or result in strong banking-sovereign-real linkages—issues that can complicate adjustment and program design. Yet, none of the CUs fully meets these OCA and banking union conditions, thus exposing their members to incomplete mechanisms to deal with asymmetric shocks or inconsistent policies.[13]

10. CUs have adopted policies to ameliorate these gaps and reduce or constrain imbalances. Various rules and mechanisms are expected to prevent imbalances or facilitate intra-CU

[10] As defined in the *Balance of Payments and International Investment Position Manual, Sixth Edition* (BPM6), Appendix 3.

[11] The Target2 system links the balance sheets of the Eurosystem.

[12] The literature on OCAs identifies several conditions under which CUs work well: highly symmetric business cycles and common shocks, a high degree of labor mobility, significant wage and price flexibility, and having in place a system of fiscal transfers.

[13] For the EMU, see Krugman (1993), Eichengreen (1998), De Grauwe (2010), Handler (2013). For the ECCU, see Zhao and Kim (2014). For the CFA franc zones, see Couharde et al. (2012).

adjustment. They aim to protect the union from the moral hazard resulting from the shared currency and, where relevant, the pooling of reserves:

- *On fiscal policy*, CUs typically establish rules to avoid the unsustainable buildup of debt and ensure that members' fiscal policies remain consistent with the inflation objective or the commonly chosen exchange rate regime. This is because one member's policy shortcomings would have negative intra-union spillovers. Yet, these rules have not always been strictly enforced.

- *On banking oversight*, CUs typically establish elements of a banking union, such as centralized supervision and/or resolution, to an extent that varies across unions. A single regulatory and supervisory framework can help contain domestic and systemic risks and curb the moral hazard attendant with common backstops (IMF, 2013).[14] Specifically, a common financial oversight framework (common supervision and resolution) can limit negative bank-sovereign links that impair the transmission of monetary policy and fragment financial markets. However, the banking unions remain incomplete in all four CUs, and so it is important in a program context to be clear about where responsibility for the various aspects of bank oversight lie.

- *In other areas*, policies generally seek to achieve intra-union flexibility. Policies are geared towards promoting labor market mobility and product market competition. These are expected to facilitate relative price changes within the CU. However, as the history of balance of payments crises in CU members illustrates, such flexibility has not always been sufficient to generate the needed intra-CU adjustment.

- *Some CUs have explicit policies to support reserve buildup.* When reserve coverage levels are important, CUs establish rules (or incentives) on the required repatriation of export earnings to ensure the effective pooling of reserves. However, avoidance of the repatriation requirements, if possible, can still result in insufficient common buffers.

11. CUs have also established safety net instruments to provide financial support to their members. Various mechanisms are in place across the different currency unions, each of them interlinked with the union's exchange rate regime.

- *EMU*. In the EMU, any direct provision of financing of member states by the central banks is prohibited. Instead, the European Stability Mechanism (ESM) may provide support under strict conditionality, if it is indispensable to safeguard the financial stability of its members or the euro area as a whole. The ECB can extend liquidity under its policies, responding to

[14] Common liquidity provision may impact the (flexible) exchange rate; common reserve backstops may impact the viability of the (fixed) exchange rate.

needs that emerge in the banking system and which can also cover balance of payment needs, for instance in the case of deposit flight.[15]

- *Fixed Regime CUs*. The other three CUs have provided member governments with varying degrees of access to central bank overdrafts (first Background Note). Member state sovereign overdrafts have been eliminated in the WAEMU, but are still in place in CEMAC (albeit with limits) and, despite very limited use in practice, in the ECCU (again subject to strict limits). All three unions have limits on the central banks' holdings of Treasury securities issued by their CU's member states. Emergency liquidity support to banks is typically provided on a one-off basis in the ECCU;[16] it is currently not part of the standard toolkit in either CEMAC or WAEMU, although it is not legally prohibited, and is currently under preparation in these unions.

THE NATURE OF BALANCE OF PAYMENTS NEEDS IN CURRENCY UNIONS

12. CU members can experience balance of payments problems. Like other countries, members of a CU or union-level institutions may adopt policies (or experience shocks) that are inconsistent with the expected path of the common exchange rate.[17] In turn, this could lead to a sudden and persistent balance of payments deficit, putting pressure on the union's currency or reserves. In the past (second Background Note), such balance of payments needs occurred in circumstances as varied as: severe terms-of-trade shocks; structurally misaligned currencies (e.g., the WAEMU and CEMAC programs of the mid-1990s); fiscal and banking crises (e.g., the 2011 St Kitts and Nevis SBA); or the need for fiscal consolidation in the face of a loss of market access (e.g., the euro area programs). While currency unions have established internal safety nets and procedures to provide financial support, as described above, the member may still experience residual balance of payments needs, for which Fund members may request financing from the Fund.[18]

13. To determine the balance of payments need of a CU member, two issues are particularly relevant. Specifically, (i) even though transactions within a currency union may take

[15] The provision of liquidity from the ECB is complemented by Emergency Liquidity Assistance (ELA) that can be provided by National Central Banks to domestic banks and which is under the control of the ECB Governing Council.

[16] In the case of Antigua and Barbuda, a 3 percent of GDP loan was granted from the ECCB to the government to buffer against deposit outflows and provide funds for bank recapitalization in the context of a Fund-supported program. In the case of Dominica, an ECCB loan was agreed as part of the financing package.

[17] CEMAC, the ECCU, and WAEMU have a currency peg; the ECB does not target the exchange rate.

[18] In fact, such IMF support is often provided alongside forms of exceptional balance of payments support (non-market flows) in a currency union that can take a range of forms. Examples include discretionary provision of (emergency) liquidity by the union central bank (when such liquidity provision also has a balance of payments impact), provision of support by a third party (French Treasury guarantee), and provision of support by other members of the currency union (ESM/EFSF) or from the regional organization (such as under the EFSM facility).

place in a single currency, as long as they take place between residents and nonresidents, they have a balance of payments impact—that is, residency rather than currency is the basis for the balance of payments need; and (ii) even though reserves are typically understood as being in foreign currency, in a currency union that issues a reserve currency (e.g., the euro), reserves may be the currency of the member (because the member does not have full control over the issuance). Hence, the balance of payments needs in CU members manifest themselves in a net drain of funds out of the country (from residents to non-residents)—regardless of whether the drain is in foreign or domestic currency or to countries inside or outside the union.[19]

14. The way the member's balance of payments problem is addressed can depend on the type of the currency union (third Background Note).

- In most past programs of CU members, the balance of payments need is related to an expected persistent unfinanced balance of payments deficit. This type of need can occur in currency unions that issue a reserve currency as well as those that do not and has typically taken the form of a shortfall in fiscal financing necessitating budget support. As in other programs, the identified financing need underpins both the case for Fund support as well as the required policy adjustment through the program.

- For the three currency unions that have a pegged exchange rate, it is possible that a balance of payments problem may reflect the need to address inadequate union-level reserves.[20,21] Since reserves are pooled in all three of these unions, insufficient regional reserves may imply an underlying external viability issue in the individual members of the union. In effect, the union is not able to support the common currency or equivalently finance the balance of payments deficit of its members, and hence the members have an external viability issue.

[19] This characterization of reserves for members of reserve-currency-issuing currency unions is consistent with the fact that, from a Fund law perspective, the euros acquired by euro-area members can be interpreted by the Fund as augmenting such members' reserve assets because a common currency such as the euro has both a "domestic" and a "foreign" currency character to euro area members. Indeed, the sale of euros by the Fund to a euro-area member drawn on another member's account with the Fund is regarded by the Fund as a sale of another member's currency, which is authorized by the Articles of Agreement (Article V, Section 2(a)), as euros held by a euro-area member can be interpreted by the Fund as claims on non-residents. This interpretation of the "foreign" currency character of the euro is further supported by the fact that the national central banks in the Eurosystem of central banks do not have full control on their euro issuances.

[20] This updates the Fund's understanding on the balance of payments needs that arise from a low level of union-wide reserves, as earlier elaborated in the 1994 paper *Need as a Condition for the Use of Fund Resources*. In that paper staff posited that since individual members do not have control over reserves of the monetary union, movements in the union's reserves would not directly provide financing for the individual member's balance of payments need, and therefore the balance (surplus or deficit) in each member's external accounts would occur as a result of the member's recourse to exceptional financing (such as arrears on external debt payments.) However, balance of payments problems in one (or several) currency union member(s) may lead to inadequate union-level reserves and threaten the validity of the currency peg, and therefore the external stability, for all currency union members. A greater recognition of this interconnectedness between members of a currency union and their shared external stability risk suggests that low union-level wide reserves therefore may present a balance of payments problemfor currency union members.

[21] This cannot occur in the EMU, which has a fully floating exchange rate and reserve currency status.

Such a situation is likely to imply the need for adjustment in several members of the union, especially those with balance of payments deficits, to rebuild pooled reserves. Examples of this type of situation are the CFA franc zone ahead of the 1994 devaluation, and more recently the program requests in CEMAC.[22]

15. A clear understanding of the balance of payments need is important for designing a successful program for a CU member. Specifically, an accurate presentation of the balance of payments need is necessary to: (i) establish the size of the problem (against which the Fund may provide funding); (ii) assess the appropriate adjustment-financing mix; and (iii) determine that, by the time IMF financing ends, programed adjustment (if implemented) will have been sufficient to allow a sustained exit from exceptional financing. To identify the BoP need, it is critical to distinguish between autonomous ("above the line") balance of payments transactions between residents and non-residents from those ("below the line") transactions only associated with financing the balance of payments need or building reserves (e.g., Fund and other program financing and debt restructuring).

16. Past cases highlight several issues and inconsistencies in the identification of the balance of payments problem. The second Background Note discusses the identified balance of payments needs in four cases—Burkina Faso, Greece, St Kitts and Nevis, and Dominica. These cases illustrate several common issues across currency union programs:

- *Implications for regional reserves*. The programs with members of fixed exchange rate currency unions generally did not discuss the implications of the national balance of payments need for the adequacy of (regionally pooled) reserves. While this was not seen as a major issue in the Caribbean cases, it was an important omission in Burkina Faso, where successive Fund-supported programs failed to eliminate the country's balance of payments deficit. Consequently, Burkina Faso remained an ongoing net user of regional reserves throughout the program. In the St Kitts and Nevis program, the framework did not clearly establish the external financing need underpinning the case for establishing a banking sector reserve fund (which could have been tied to regional reserves).

- *Budget support for sovereigns*. In this area, there were inconsistencies across programs. In the case of Greece (and other euro area members), European support to the sovereign was defined as exceptional financing. A similar treatment occurred in the Dominica program, where sovereign support from the ECCB was also counted as exceptional "below the line" financing. This treatment implied that sovereign external financing gaps needed to be closed as part of the adjustment under the program. The treatment was different in the case of CEMAC member programs, where sovereign central bank support (e.g. advances) was not

[22] When there are inadequate reserves at the regional level, program design will need to involve a decision on the contribution—as reflected in the member's programmed balance of payments surplus (ex union)—to the rise in regional reserves. This decision needs to be made jointly by the members of the union through their central bank, possibly in consultation with the Fund.

counted as balance of payments support, implying there was no need for external policy adjustment to fill this gap.

- *Support to the financial sector*. In Greece (and other euro area programs), ECB support for the banking sector was counted as autonomous "above the line" balance of payments inflows. By treating this support as autonomous, the possible adjustment need could have been understated if net inflows to the private sector (via the impact on commercial banks) had not strengthened by the end of the program.[23]

17. Support from a currency union central bank (CUCB) provided on its "own account" is external support. As discussed in the third Background Note, CUCBs are not resident in any of their members. The analytical rationale for this treatment bears close similarity to why multilateral institutions, including the Fund and regional development banks, are considered non-resident with respect to each of their members. The CUCBs are created through a treaty and make monetary and exchange policy decisions on behalf of all their members, not on behalf of any individual member. They also have their own loss-bearing capacity (capital), indicating that the "center of predominant economic interest" lies jointly with all the CUCB's members. Consequently, support provided by a CUCB on its "own account," whether for a sovereign (where permitted) or banks, is external and should be recorded in the balance of payments. In a decentralized CU, support from the central banking system of the union is, however, domestic (given its implementation by the relevant NCB) unless liquidity demand is ultimately associated with cross-border transactions. In a program context, the support from a CUCB should likely be considered as exceptional support when it meets the balance of payments need underpinning the program resulting from illiquid banks or sovereigns (see third Background Note).

18. Staff proposes following a consistent framework in measuring the balance of payments need of CU members in the future. Past inconsistencies have illustrated the need for an approach that enables the Fund to ensure evenhanded treatment across CU members in establishing the balance of payments need and to ensure adequate program financing. The third Background Note elaborates on the principles outlined above that should underlie the measurement of balance of payments need in currency union member programs.

[23] Not all transactions between the CUCB and banks should be considered "below the line" but only exceptional transactions. Regular liquidity operations are not considered exceptional and thus do not contribute to the assessment of a balance of payments need. For a more detailed discussion of exceptional financing, including the principles underlying its definition, please see third Background Note.

THE FUND'S LEGAL FRAMEWORK FOR ITS FINANCING OPERATIONS

19. Under the Articles of Agreement, the Fund's general resources may only be used to resolve a member's balance-of-payments problem.[24] Article I (v) stipulates that the purpose of GRA financing is to provide members with the "opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." Article V, Sections 3(a) and (b) establish two key conditions for the use of the Fund's general resources, namely, (i) a member should only make purchases when it represents an actual balance of payments need and (ii) it must use Fund resources to address the underlying balance of payments problem in a manner that provides adequate safeguards to Fund resources.

20. Under its legal framework (Article V, Section 3(a)), the Fund is required to adopt policies for the use of its resources to help members resolve their balance-of-payments need and ensure adequate safeguards for the use of Fund's resources. Hence, the Fund has the inherent authority to make the availability of its resources conditional on the adoption of measures by third parties or entities over which the member receiving support has no direct or indirect control (including currency union institutions). Indeed, consistent with Article V, Section 3, the Fund would be precluded from making its resources available to a member where failure to adopt these measures would undermine the success of the program or the ability of the member to repay the Fund. Thus, for example, the Fund's financing assurances policy aims at ensuring timely repayment to the Fund as well as the member's medium term external viability. Accordingly, the Fund requires financing assurances to be received from third parties in circumstances where such financing is critical to the success of the program.

21. The Fund's Conditionality Guidelines, however, do not operationalize the provision of policy assurances by CU institutions, which can be required pursuant to the Fund's authority. The Fund's Conditionality Guidelines (the "Guidelines") focus on (a) the types of policies a member is required to adopt as a condition for that member's use of Fund resources; and (b) the modalities that will be used by the Fund to monitor these policies, such as prior actions, performance criteria, indicative targets, and structural benchmarks. Since the Guidelines focus on the member's own policies (national policies), they only apply with respect "to variables or measures that are reasonably within the member's direct or indirect control."

22. Hence, while the Fund has the legal authority under the Articles of Agreement to require assurances from currency union institutions, **the forms of conditionality laid out in the Conditionality Guidelines cannot be applied to union-level institutions, as they are currently**

[24] While the general principles on safeguarding PRGT resources are similar to those for the GRA, the legal basis and framework for the use of PRGT resources set out in the PRGT Instrument are different. (For more details see *Staff Guidance Note on the Use of Fund Resources for Budget Support,* EBS/10/44, 3/24/2010.) Nevertheless, for purposes of this paper, the same considerations apply for policy assurances that may be sought for members in a currency union seeking access to the GRA or the PRGT.

formulated. The Fund has exercised this authority in the past (e.g. with the establishment of QPCs on monetary aggregates in the CFA franc zones), but this was mostly before the 2002 Conditionality Guidelines were adopted. Box 2 provides examples of structural conditionality applied to CUs in the past.

23. **Nonetheless, to fulfill the safeguards requirement in Article V, Section 3(a), the Fund has the authority and thus can obtain assurances over policy actions necessary for program success**. While the Guidelines as currently drafted do not provide the vehicle to articulate such assurances from CU institutions, as outlined in the next section, the Fund has asked for, and received, assurances from CU institutions in several past Fund-supported programs.

OPTIONS: POLICY ASSURANCES AND IMPLEMENTATION ISSUES

24. **CU institutions, such as CUCBs, often support their members when they undertake adjustment**. CU central banking systems can provide support in the form of liquidity for illiquid but solvent domestic banks while some central banking systems, can also provide support to a member sovereign. In many cases, CUCBs also support adjustment through their role in financial sector oversight. In several past program cases, the CUCB has provided assurances to the Fund on the nature of its intended support (Box 2). Depending on the CU, other institutions assist with financial supervision, bank resolution, and support for structural measures. This section outlines potential options, and associated modalities, for codifying this policy support in the future.

A. Options for Articulating Policy Assurances

25. **The paper considers two options on how to operationalize the Fund's mandate to seek policy assurances from union-level institutions, both of which are consistent with the Articles of Agreement**. *Option 1* would be to amend the Conditionality Guidelines, which would allow the use of standard conditionality tools (either as prior actions, performance criteria, indicative targets, or structural benchmarks) over actions by union-level institutions. *Option 2* would entail formalizing general guidelines on policy assurances from union-level institutions, which would establish principles and modalities for seeking such assurances. These guidelines would serve a role analogous to the Fund's policy on financing assurances that, as noted above, also applies to third parties and entities other than the member's own national authorities, and establishes when Fund financial assistance can—or cannot—proceed based on financing prospects.

26. **Each option has its own advantages:**

- **Option 1**. Its main advantage is that actions that are required by the union-level authorities would be in embedded in a clear, robust and transparent procedural framework (e.g. performance criteria and structural benchmarks) that, inter alia, requires specific Board decisions in the event the relevant assurances are not implemented (i.e. waivers of performance criteria). Moreover, Option 1 would be simpler to communicate.

- **Option 2**. Its main advantage is that it ensures that the Guidelines of Conditionality continue to be focused on the policies of the national authorities. This would be consistent with the overall approach advocated in this paper: namely that union level policies should generally support the policies of the national authorities, which will be the policies of first resort in the design and implementation of any adjustment program. [25] Moreover, Option 2 would mitigate the sensitivities that arise from the fact that decisions in union-level institutions are generally made on behalf of all CU members and not only on behalf of the borrowing member.

27. On balance, and with a view to gaining a broad consensus at the Executive Board, staff is of the view that the advantages of Option 2 outweigh the advantages of Option 1. In this regard, it should be emphasized that the substantive standard required by Option 2 would be the same as that required for Option 1: the measures needed from the union-level institution would have to be considered critical for program success, they would have to be clear, specific and monitorable, and it would need to be clear from the relevant documents (including the Summing Up) that the non-observance of a measure or policy action could result in the non-approval of an arrangement or the non-completion of a program review. Furthermore, neither option would infringe upon the independence (or legally-provided autonomy) of union-level institutions, since the institutions would decide what measures or policy actions to take—just as any independent central bank or monetary authority does, for example, in non-CU members.

28. Union-level policy action will not be the first resort. Generally, programs should be organized around policies under the direct or indirect control of the national authorities, given that the Fund is a member-based organization. However, in circumstances when actions under the control of the national authorities are insufficient to solve the member's balance of payments problems and ensure the member's capacity to repay, or when policies by union-level institutions are the source of the balance of payments problems, policy action by union-level institutions may become critical to the success of the program. This is most likely to occur in cases where the national authorities have delegated various policy instruments, or where adjustment through national policies alone is insufficient to achieve program objectives.

29. The remainder of this section discusses several implementation issues. These include: (i) how to determine when a union-level action might be considered critical to program success; (ii) the modalities for implementing Option 2; and (iii) other issues including program implications, the evolution of assurances during a program, and next steps.[26]

[25] The modalities of the Conditionality Guidelines with respect to waivers for non-observances of performance criteria and the related misreporting policies would not apply to policy assurances under Option 2. This is in line with the approach taken under the policy on financing assurances. Staff considers the existing framework for misreporting to be aimed specifically at the member's own actions and thus staff does not recommend establishing a misreporting framework with regard to union-level policy assurances.

[26] If Option 1 were chosen, the modalities would be straightforward; they would follow those used for policy actions by the borrowing member.

B. Criticality for Program Success

30. In a currency union context, there may be circumstances when a union-level action is critical to program success. The implementation of policies at the union level may not be necessary in all, or even many, programs of CU members, insofar as adjustment can be achieved through policy actions at the national level—the primary level for engagement between the Fund and its members. Hence, even in the context of currency union membership, it would be expected that programs should be built primarily around national policy actions. Thus, assurances regarding actions by union-level institutions should be sought *only* where (i) such actions are critical to program success, program safeguards, or for monitoring the implementation of a program; [27] and (ii) domestic policies or actions are not a viable substitute for union-level action.

31. As expected, adjustment in past programs of CU members relied more heavily on fiscal and structural adjustment measures than other programs (Box 4). Programs of CU members included a larger number of structural measures across sectors (including fiscal), as well as larger and—when controlling for other factors—more front-loaded fiscal adjustment. A plausible explanation for this pattern is that it reflects the delegation of monetary and exchange rate policy, which requires greater efforts through the policy tools available to national authorities, as may be the case also in countries that are not part of a CU but have a fixed exchange rate regime. While measures available to national authorities have generally proved sufficient to resolve the underlying balance of payments problems, they tended to be associated with steeper losses in output, and higher debt than programs where all policy tools are available to the national authorities (Box 5). If extreme enough, these "side-effects" can make underlying adjustment only through domestic policy action infeasible, placing program objectives and consistency at risk. In such circumstances where national policies or actions alone cannot satisfactorily resolve the member's balance of payments problems, the design of the program may need to consider alternative strategies where national policies are complemented by measures delegated to, and within the mandate of, union-level institutions, taking into account their legal and institutional framework.

32. Experience suggests that where union-level actions were deemed critical at the time to the success of a member's program, the measures typically affected the member only. The experience outlined in Box 2 suggests that most union-level actions, particularly since the approval of the 2002 Conditionality Guidelines, revolved around country-specific financial regulations that did not affect other members of the currency union. The experience in the euro area programs suggests a similar conclusion: while the Fund made no formal request for action at the union level in these programs, this largely reflected the fact that most critical regulatory actions were, at the time, under the control of the national authorities.

33. However, the recent transfer of some responsibilities from euro area members to the center suggests that equivalent (country-specific) measures may require union-level action. As outlined in Box 3, some supervisory actions previously under the responsibility of the national

[27] Oral assurances are an exception to this criticality requirement, since they cannot be made with respect to critical actions, but are rather "complementary to or elaborating upon" written assurances (see ¶40 below).

regulatory authorities now fall under the ultimate control of either the SSM or SRM. This implies that, henceforth, if there are measures in the banking sector that are critical to program success (e.g., undertaking stress tests, ensuring adequate provisioning and capitalization of banks, or taking steps toward resolution), the use of Fund resources could not proceed without satisfactory assurances from the relevant union-level authority. In the event the Fund is considering a new or ongoing arrangement with a CU member—and there are concerns about the soundness of the financial system—the Fund will be precluded from making financing available unless assured, based on its own analysis and judgement, of the initial situation of the financial system and that the proposed actions during the Fund-supported program will restore the soundness of the financial system. Consequently, some form of union-level assurances will be necessary to allow the Fund to lend, while transparency about the provision of assurances will give confidence to the membership that the Fund is acting in an evenhanded manner.

34. Moreover, there may be situations in which programs cannot succeed without actions by CU institutions that impact union-wide policy settings. Experience suggests such cases are likely to be rare (Boxes 1 and 2). They are most likely to emerge in circumstances where several union members face severe imbalances at the same time, placing the sustainability of the union in jeopardy. There are only a handful of cases since the early 1990s in which such actions were sought, and these were all in CUs with a fixed exchange rate regime.[28] As adjustments in union-wide policy actions may create adverse or uneven intra-union spillovers, the Fund would always need to be mindful of—and should seek to mitigate—the potential for such spillovers in program design. Ultimately, it would be for the relevant union-level body to weigh intra-union tradeoffs and decide whether to undertake the requested action, albeit recognizing that a failure to do so may preclude Fund support for one or more of its members.[29]

35. The threshold for the Fund to make the use of its resources conditional on a policy action by a union-level institution is the same as for policies under the member's own control: the measure must be deemed critical to program success. Criticality is a judgment call and, as is the case in non-CU programs, staff reports should include a justification for the criticality of any union-level action sought. The judgment could, for instance, be based on the importance of the measure for financial sector (and hence macroeconomic) stability, in the case of a financial oversight measure. It could follow from an assessment that country-level adjustment could not realistically resolve the balance of payments problem without supportive union-level actions, as in the recent programs of CEMAC members, or because of the cost of adjustment. It could also reflect the importance of the measure to meeting the required safeguards for Fund resources. Nonetheless, the standard for criticality should be equivalent to that established in the Guidelines on Conditionality

[28] The 1993 data cut-off reflects the availability of data in the MONA database.

[29] An example where the union as a whole benefitted, despite intra-union spillovers, was the 1994 CFA devaluation. This did not improve balance of payments deficits in all members equally, but it succeeded in increasing regional reserve coverage and ultimately preserved the union.

(¶7), where a measure should be "of critical importance for achieving the goals of the member's program or for monitoring the implementation of the program."[30]

C. Implementation Modalities for Option 2

36. As with conditionality at the member level, policy assurances from union-level institutions are expected to share several characteristics. The Fund will seek written undertakings of any assurance provided by the CU institution stating that it will take appropriate actions that are critical for the successful completion of the program. Such assurances would be the outcome of a dialogue between Fund staff and the CU institution, which takes account of the legal and institutional framework of the CU institution. The assurances would also need to be communicated to the Board, and there would be an expectation that these assurances be published. In addition:

- Assurances should be provided by the union-level institution that has the mandate and responsibility for the policy action to be taken (or target to be met), and has control over such actions (or targets). The Fund will not seek assurances that are inconsistent with the union-level institution's mandate as articulated in the legal framework of the CU.

- Similarly to undertakings by the national authorities of a borrowing member, understandings on the assurances should be reached directly with the relevant union-level institution. The provision of the assurance by the union-level institution would be voluntary and would represent understandings reached between the Fund staff and the relevant institution. Accordingly, it is for the relevant institution to decide whether to (a) provide the assurance and (b) follow through on the intentions set forth. However, a failure with respect to (a) or (b) may undermine the Fund's ability to make resources available to the member, given the criticality of the actions or targets for program success. That is, the Fund may decide not to approve a new arrangement or complete a review, absent satisfactory corrective measures or a redesign of the program to ensure its objectives are likely to be met. The implications for the program would be similar to those that arise when adequate financing assurances are not forthcoming.

[30] Pursuant to the Conditionality Guidelines conditions can also be established on "variables or measures that are reasonably within the member's direct or indirect control and that are […] necessary for the implementation of specific provisions of the Articles or policies adopted under them" (Guidelines on Conditionality, 2002). Conditions to implement specific provisions of the Articles include the avoidance of exchange measures subject to Fund jurisdiction and of import restrictions for balance of payments reasons." (Guidelines on Conditionality, SM/02/276, Revision 1) A member's obligations under the Articles remain the member's, even if such member has delegated powers to a currency union. (The European Economic and Monetary Union and the International Monetary Fund-Main Legal Issues Relating to Rights and Obligations of EMU Members in the Fund, SM/98/131) Therefore, in the event that a currency union institution introduces an exchange restriction or multiple currency practice (MCP) that operates within a member's territory, such a measure would not constitute a non-observance of the standard performance criterion on the non-introduction of exchange restrictions and/or MCPs—since the member would not be considered to have control of such measure—but it would still constitute a breach by that member of its obligations under the Articles, unless the member seeks approval of the measure from the Fund.

- Assurances would also need to be provided in a **clear, specific, and monitorable (including time-bound)** form. Meeting this standard may imply the need to define the specifics of quantitative or other targets (e.g. as currently in practice with a Technical Memorandum of Understanding) and elaborate the specific content of the assurance or other relevant details. Assurances not meeting the standard could not be considered adequate for the purposes of Option 2.

37. Policy assurances would normally be conveyed publicly and in writing. Provided they meet the characteristics set out above, however, there could be flexibility regarding the form in which they are expressed. Two options for making the assurance public are as follows:

- *A letter to the Managing Director of the Fund.* Subject to prior consultation with the union institutions, this letter would be issued to the Executive Board as part of the program documentation and published as part of the relevant program documents, subject to the consent of the relevant union institutions. This is the modality currently being applied for the regional actions critical to the success of the prospective programs of CEMAC members. Any definitional or other information to make the assurances specific and measurable should be included in the letter, but may also be included in an attachment to the letter. In addition to actions critical to program success, the letter could also discuss other policies the union-level institution intends to take in support of its member's program, although in these cases the letter should clearly specify which measures are truly critical and thus constitute the assurances. The staff report will need to outline staff's views on how the measures are critical to program success (and the implication if a measure is not being taken), as well as any information necessary to make clear staff's understanding of the specific measures and how each measure will be monitored.

- *A published statement by the union institution*. Provided the statement outlines the intended policy measures in a similarly clear, specific, monitorable, and time-bound way as in the modality of a letter, it would be an acceptable substitute for a communication addressed directly to the Fund. The statement would be included in the package issued to the Executive Board as part of the program documentation and should be included in the bundle of program documents to be published. If the assurances provided in the published statement do not meet the standard of being "clear, specific, monitorable, and time-bound", the published statement should be supplemented by a letter to the Managing Director, as specified above. If there are confidentiality concerns with respect to the policy-assurances, the CU-level institution may, in a narrow set of circumstances, opt for the modalities outlined in ¶40 below.

38. Whichever of these modalities is chosen, the dialogue and consultation with the CU institution would be expected to start early, at the program design or review mission stage, to reach an understanding on the content of the assurances, as well as any coordination/ex ante consultation with Fund staff or information sharing (e.g., on bank-by-bank data) necessary to set or monitor the assurances.[31] The assurances should normally be obtained by the time Fund staff submits the program documents for interdepartmental review. In line with the practice on prior actions, the written communication from the CU institution that would include these policy assurances would be expected to be made available to the Executive Board no later than five working days before the Board meets on use of Fund resources by the member but in any event no later than the Board's consideration of a request/review.

39. In a narrow set of circumstances—those identical to the conditions established under existing policies—the assurances could be provided in a confidential form.[32]

- *Side-letters*. The use of confidential side letters should be in line with current requirements and restrictions on the disclosure of confidential policy understandings per the Fund's policy on side letters in the use of Fund resources.[33] The assurance would still need to meet the characteristics elaborated above. As under the current policy, side letters containing policy assurances from CU member institutions would be shared with the Board in a restricted meeting and would not be published. Also in line with the current policy, the full text of a side letter is to be communicated to the Board in principle, but the Managing Director, at the request of the authorities, may delete specific information from the copies that are communicated to Directors under very narrow circumstances.[34] As is the case with the side letter policy, the implementation of policy assurances would be monitored and specifically reported to the Board while maintaining the confidentiality of the original understanding.[35] However, the deletion of information relating to the original understandings on policy

[31] This would include cases where Fund staff needs to be involved in the design of financial supervisory actions such as stress tests or asset quality reviews (AQRs).

[32] Side letters are to be used sparingly and only in those circumstances that the authorities consider, and management agrees, require such exceptional communication. The use of side letters can be justified only if their publication would directly undermine the authorities' ability to implement the program or render implementation more costly. Accordingly, their use will normally be limited to cases in which the premature release of the information would cause adverse market reaction or undermine the authorities' efforts to prepare the domestic groundwork for a measure.

[33] See *Review of Side Letters and the Use of Fund Resources,* EBS/02/89, May 28, 2002, and *Decision on Side Letters and the Use of Fund Resources,* Decision No. 12067-(99/108), September 22, 1999. See also Documents for October 27, 2006 meeting of the Ad Hoc Committee on the Treatment of Confidential Information. Confidential memo October 20, 2006.

[34] Specifically, the decision allows deletion where the information is of such specificity that (i) it is substantially immaterial to the Executive Directors' consideration of the request for Fund resources, and (ii) disclosure would seriously hamper the authorities' capacity to conduct economic policy, or confer an unfair market advantage upon persons not authorized to have knowledge of the information. The following are identified as types of information that might be deleted pursuant this provision: figures regarding foreign exchange markets (e.g., intervention triggers or amounts), names of specific banks or companies, or specific dates for the introduction of certain policy measures. (*Decision on Side Letters and the Use of Fund Resources,* Decision No. 12067-(99/108), September 22, 1999. See also Documents for October 27, 2006 meeting of the Ad Hoc Committee on the Treatment of Confidential Information. Confidential memo October 20, 2006).

[35] *Summing up by the Acting Chair, Review of Side Letters and The Use of Fund Resources*, BUFF/02/80 (6/12/2002).

assurances and their implementation from relevant staff reports would be permitted in cases where such information would have qualified for protection through this policy.

- *Oral assurances.* The Board has determined that oral assurances are unreliable when used in the context of a Fund-supported program.[36] Therefore, undertakings of the authorities (or CU-level institutions) that are judged to be critical to a member's Fund supported program must be set forth in a written communication from the authorities (or CU level institutions) that is disclosed to the Board.[37] Oral assurances may be accepted only where (i) the understandings would not be critical to the Fund-supported program's success, but merely complementary to or elaborating upon written assurances, and (ii) the use of a side letter would still not be sufficiently effective in maintaining confidentiality (e.g., because the existence of a side letter would necessitate informing domestic legislative or other bodies). However, the use of oral assurances must be highly exceptional as they are inherently less likely to be "clear, specific, and monitorable." Consequently, the use of oral understandings in the past has also been extremely infrequent. [38] In line with the Summing Up on the 2002 Discussion of the side letter policy, if oral assurances are used, the Board would need to be informed of these assurances in "an appropriate manner."[39]

D. Operational Aspects

40. Update of assurances. The assurances (or conditionality in the case of Option 1) from union-level institutions would be expected to be updated or amended, with new understandings reached between the authorities and Fund staff in cases where new targets or actions have become critical to the program—or if staff and the authorities no longer believe the actions to be critical to the program (e.g., due to other measures taken in the context of the program). The assurances provided by the union-level institution(s) should be reexamined, in conjunction with national and union-level authorities, at the time of each review. Performance against union-level assurances should be assessed in each review, although in a situation where programs with several countries rely on a shared set of policy assurances, these assessments could, where relevant, refer to other recent Board assessments. However, the assurances, and the possible need for additional

[36] In the context of the 2002 review of the side letter policy, Directors noted that resort to oral understandings between the Fund and national authorities has been rare and should continue to be discouraged as such undertakings lack transparency and are difficult to monitor. *Summing up by the Acting Chair, Review of Side Letters and The Use of Fund Resources*, BUFF/02/80 (6/12/2002).

[37] Documents for October 27, 2006 meeting of the Ad Hoc Committee on the Treatment of Confidential Information.

[38] Only one oral assurance is reported to have been used between 2002 and 2006, which involved an understanding to limit foreign exchange market intervention (Documents for October 27, 2006 meeting of the Ad Hoc Committee on the Treatment of Confidential Information. Confidential memo October 20, 2006.), and five assurances were used between 1999 and 2002, which reflected authorities' confidentiality concerns that could not be addressed through the use of a side letter ("Review of Side Letters and the Use of Fund Resources," May 2002).

[39] The Board would be informed in a manner that is analogous to the procedure used for side letters. The director of the relevant Area Department would memorialize the oral assurance in a memorandum that will be issued to management for clearance. The memorandum, once cleared by management, will be treated as a side letter, forwarded as such to the Secretary's Department and discussed by the Board in a restricted Board meeting, with no minutes being recorded.

assurances, should be considered at least semi-annually, in the context of reviews for one or more of the program countries under the shared set of policy assurances.

41. Discussion of assurances in the staff report. Staff is expected to discuss clearly in the staff report why resolution of the member's balance of payments problems cannot be achieved solely with domestic policies and which union-level measures are critical to program success. The staff appraisal should state that the implementation of measures is a critical consideration for completing the review. Staff reports would also be expected to assess the implementation of previously provided assurances, including any delays or mitigating measures.

42. Inclusion in country program documents. The written communication outlining union-level assurances (or conditionality in the case of Option 1) should be included in the package of documents for program requests and for each program review.

43. Board endorsement of assurances. In line with the discussion in the staff appraisal, the Board is expected to take a position on which measures will be considered critical for the approval of an arrangement or the completion of a review under a Fund-supported program. In the case of Option 2, the policy assurances from union-level institutions would need to be endorsed by the Board, and shall be included in the relevant summing up[40] and chairman's statement, and published as part of the latter in accordance with the Fund's transparency policy.[41] This procedure would be equivalent to the treatment granted to performance criteria under the Guidelines on Conditionality, where PCs are also established by the Board and set forth in the respective Fund arrangement and LOI/MEFP and published as part of the package containing the program documents.

44. Union-wide background papers. In some circumstances, it may be desirable for staff to prepare a paper on the union-wide situation to provide context for the proposed measures at the union level. This would not be a general requirement. Instead, it would be a judgment call, with the need most likely when there is a union-wide shock (or inadequate union-level reserves) requiring simultaneous adjustment in several CU members and/or when the measures under consideration are likely to have a union-wide impact and potential for spillovers. Such analytical pieces should, where possible, be undertaken ahead of the initial program request and be repeated at the same frequency as the program reviews (and at least semiannually). In cases where several countries in a union concurrently have Fund-supported programs and union-level actions are critical, it is likely that one report for the union within a six-month period will be sufficient. These papers should also be discussed at the Board, preferably in a standalone meeting, as they are background papers for arrangement requests or reviews.

[40] See for example Gabon (BUFF/17/44), Cameroon (BUFF/17/46), Chad (BUFF/17/51), and Central African Republic (BUFF/17/57).

[41] Confidential information would be deleted from the chairman's statement before publication in accordance with the Fund's transparency policy. Assurances provided through a side letter or orally would not be included in the summing up or chairman's statement.

45. Next steps. Since Option 2 proposed by staff as presented in this paper implies the codification of past practice with respect to policy assurances granted by union-level institutions, if this proposal were to be adopted by the Board, it will take effect immediately. Thus, there would be no need for transitional arrangements.[42] If Option 1 were to be adopted by the Board, however, staff will need to come back to the Executive Board with a supplementary paper with a proposed decision modifying the Guidelines on Conditionality.

ISSUES FOR DISCUSSION

46. Directors may wish to consider the following issues for discussion:

- Do Directors agree with the description of the types of balance of payments need that can arise in currency unions outlined in the third section?
- Do Directors agree that Option 2 is the preferred approach for the Board to adopt?
- Do Directors agree with the modalities and operational aspects outlined in the fifth section, and the requirement for assurances to be clear, specific, monitorable, and time-bound?
- Do Directors agree that they should discuss at regular intervals a union-level paper most likely when several members of a union are hit by the same shock, there are inadequate reserves, or when there is the potential for significant intra-union spillovers?

[42] For ongoing programs, the adopted proposal will apply from the next review.

Box 1. Programs with CU Members—Lessons from Recent Ex Post Evaluations

The EPEs for the Greek, Irish, and Portuguese programs all agree that the ECB policy actions were critical for program success (in terms of its accommodative monetary policy, bond-buying programs, and liquidity provision). The full-allotment liquidity provision for banks and the relaxation of the eligibility requirements for collateral were essential for achieving banking sector stabilization, which was key for program success. Mostly important, the ECB's various bond-buying programs and "whatever it takes" policy statement were responsible for bringing sovereign bond spreads down, which eased market concerns over debt sustainability and provided these countries with space to undertake their adjustment programs. The Portuguese EPE noted that "[t]he support of the EU was of vital importance. ECB financing was determinative for Portugal's recovery and current stability." and that "Portugal's access to markets was clearly facilitated by, if not completely dependent on, accommodative ECB financing." Similarly, Ireland's EPE highlighted that "it is difficult to see that the program, even if fully implemented by the Irish authorities, could have succeeded without further actions to stabilize the euro area and address tail risks."

The EPE for St. Kitts and Nevis confirmed that ECCB participation was critical to ensuring continued financial sector soundness throughout the program. At program inception, a key concern was the potential impact of the necessary large debt restructuring on the real and financial sectors given the strength of bank-sovereign links. The ECCB played two key roles in mitigating risks. First it administered a banking sector reserve fund (BSRF) to backstop the system in the event of liquidity pressures (or a bank run). Second, the ECCB strengthened supervision and undertook regular stress tests to quickly identify changes in bank soundness. While the BSRF was not ultimately used, the authorities considered it a valuable safety net which helped mitigate liquidity pressures during the debt restructuring.

In general, the Euro Area EPEs raise the question on how the Fund could require assurances from regional-level entities in cases where a specific policy action becomes desirable for the program country but not for the union as a whole. Given the criticality of union-level policies for program success, the EPEs call for a clarification of the Fund's policies in the context of currency unions and highlight the need to have formal upfront assurances from union-level institutions. When arguing whether the exceptional access criteria were observed, the Irish EPE states "With program success depending critically on actions by third parties that were not directly bound by the program, an issue arises if Criteria 3 [regaining access to capital markets] and 4 [strong prospects of program success] were met." The Irish EPE concludes that "Ways should be explored to secure stronger upfront commitments and understandings from monetary union authorities, where such steps are critical for program success." Similarly, the Portuguese EPE reiterates that the "incorporation of ECB assurances into the program might have to be a prerequisite to being able to assure the Board that the program will be successful".

Box 2. Experience with Policy Assurances from Union-Level Institutions

This box discusses experience with policy assurances provided at the currency union level.

Various forms of assurance over union-level policy actions have been used in past programs with CU members. These policy actions have generally, but not exclusively, been over (supervisory) actions affecting only the country with the Fund-supported program. The rare exceptions have been cases where the union's sustainability was at stake.

- *Conditionality and assurances associated with a single member*. Prior to the 2002 Conditionality Guidelines, quantitative conditionality was applied to net domestic assets of the local branch of the regional central bank in programs of members of the CFA franc zone (IEO, 2016). Beyond this, the table below refers to relevant examples of structural conditionality and other policy intentions included in programs MEFPs with CU members since 1993, highlighting cases where assurances were provided over actions under the control of union-level institutions. Programs of several ECCU countries included conditionality on actions by the ECCB. In one case, the ECCB sent the national authorities a letter assuring them "that the ECCB will take the necessary steps for … [the benchmarks] to be observed within the time frame specified in … the MEFP". In the euro area programs, financial sector conditionality was applied at the national level through national institutions although, as discussed below, similar actions in future programs may need to involve union-level action.

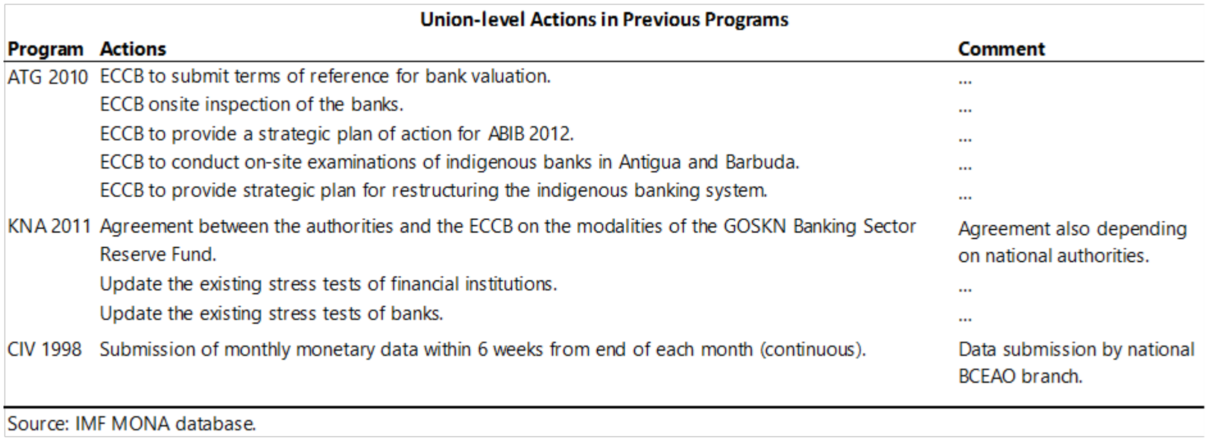
- *Actions affecting multiple members*. As documented in IEO (2016), Fund support for CFA franc zone members during 1994-95 was predicated on a devaluation of the CFA franc. Similarly, actions to implement the 2009 BEAC safeguards action plan were preconditions for Board consideration of new program requests and reviews of existing arrangements with CEMAC countries in the 2010-17 period.

- *Other commitments in the MEFP*. While not formal conditionality, references to commitments made by regional authorities have sometimes appeared in the borrowing member's MEFP. Some examples are documented in the table below. [1]

In some cases, no union-level action was requested, although such action is likely to have helped to improve program outcomes. Box 1 describes several examples identified in the EPEs of euro area programs, including measures related to liquidity provision and policy actions by the ECB, which were said to have aided program success. Yet, no formal assurances on these policy actions were sought, and hence there was no transparent link in the program documents to the criticality of these actions for the individual programs. Such explicit assurances would have established more clearly the basis for staff's assessment that programmed policies would resolve the member's balance of payments need, and increase the Board's comfort in approving a new Fund-supported program and completing reviews.

[1] It is envisaged that a policy on policy assurances, as proposed in this paper, which focuses on macro-critical measures, would coexist with the continued practice of reporting in program documents undertakings made by CU institutions that are considered a useful part of program design, but which may not meet the criticality standard.

Box 2. Experience with Policy Assurances from Union-Level Institutions (concluded)



Union-level Actions in Previous Programs

Program	Actions	Comment
ATG 2010	ECCB to submit terms of reference for bank valuation.	...
	ECCB onsite inspection of the banks.	...
	ECCB to provide a strategic plan of action for ABIB 2012.	...
	ECCB to conduct on-site examinations of indigenous banks in Antigua and Barbuda.	...
	ECCB to provide strategic plan for restructuring the indigenous banking system.	...
KNA 2011	Agreement between the authorities and the ECCB on the modalities of the GOSKN Banking Sector Reserve Fund.	Agreement also depending on national authorities.
	Update the existing stress tests of financial institutions.	...
	Update the existing stress tests of banks.	...
CIV 1998	Submission of monthly monetary data within 6 weeks from end of each month (continuous).	Data submission by national BCEAO branch.

Source: IMF MONA database.

Statements in Selected Currency Union Program MEFPs

Togo 2008	"The monetary authorities will closely monitor money and credit growth in Togo. If the monetary expansion fuels inflation or imprudent lending practices, the monetary authorities will take appropriate measures, including a possible increase in reserve
Guinea-Bissau 2016	"[T]he government expects the Banking Commission to promptly conduct on-site inspections of the banks to assess the health of the banking system and require those banks currently noncompliant with regulatory norms to prepare time-bound action plans to remedy these violations."
Côte d'Ivoire 1998	"The BCEAO is to pursue a prudent regional monetary policy consistent with the objective of improving the zone's net foreign assets and the fixed parity of the CFA franc. […] In its conduct of regional monetary policy, the BCEAO will continue to rely exclusively on indirect instruments […] The BCEAO's intervention rates are to be set in relation to the level prevailing in the French money market, consistent with the exchange rate peg. "

Source: Selected program documents.

Box 3. Banking Oversight Issues in Europe's Banking Union

With the establishment of the Single Supervisory Mechanism (SSM) in Europe, significant authority in the area of banking sector supervision was transferred to union-level institutions. Thanks to the Single Rulebook, and at the impetus of the SSM creation, banking sector regulation is largely harmonized, with only a small set of options and national discretions remaining (mostly related to macro-prudential issues). Prior to the SSM, supervision and resolution were fully under the control of the National Competent Authorities (NCAs). The creation of the SSM—comprising the ECB and NCAs—in late 2014 was a response to the realization from the crisis experience that there was a need for a stronger banking union (e.g. Goyal et al., 2013); the other three CUs had elements of a banking union in place. To round-out the banking union, the Single Resolution Mechanism—which exercises the transferred authority on specific banking sector resolution issues—came into force in January 2015.

The ECB is now the ultimate supervisory and licensing authority for banks operating in countries participating in the SSM.

- **Banks are supervised directly by either the ECB or the NCAs.** The ECB directly supervises the large or significantly cross-border banks ("significant institutions" or SIs). There are about 130 of them. Such supervision is done by joint supervisory teams (JSTs), with one created for each supervised SI. Each JST is led by the ECB and includes team members drawn from the NCAs where the bank operates. NCAs directly supervise all other banks ("less significant institutions" or LSIs) incorporated in their jurisdictions under the oversight of the ECB.
- **However**, **the ECB retains the ultimate control over supervision.** Supervision has been transferred to the ECB (through an EU regulation) and establishes areas of shared competence with NCAs. While this implies that NCAs have limited independence, NCAs remain under the 'oversight' of the ECB. In addition, the ECB has the option to declare that an LSI is a SI at any time, bringing it under its direct supervision.

Fund conditionality in the context of the SSM would require a careful recognition of the control and implementation capacity of NCAs vs. the ECB within the SSM. As the ultimate supervisory and licensing authority, the ECB would be assumed to be in agreement with proposed Fund conditionality in the area of banking supervision. The specific implementation of supervisory actions may be feasible at the NCA level, but given the ECB's option to declare an LSI an SI at any time, such actions are also under the indirect control of the ECB.

Box 4. Program Design and Conditionality

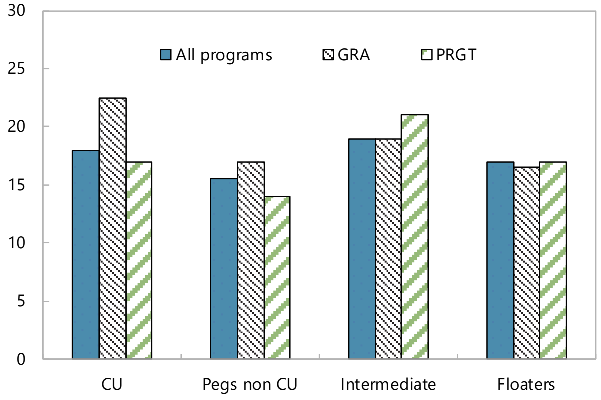
This box investigates differences between CU and non-CU programs along the dimension of program design and conditionality, showing that CU programs have relied more heavily on conditionality, especially structural conditionality, in the real and fiscal areas. While a full assessment of conditionality should also take into account the qualitative dimension, this section focuses on quantitative indicators that allow cross-country comparison.

Heavier conditionality

Simple descriptive statistics show that CU programs tend to have heavier conditionality, especially in the fiscal and structural areas, than other programs. In particular, while the median number of program conditions (both quantitative and structural) have been broadly the same when considering all programs together or PRGT-supported programs only, GRA-supported programs for CU members faced a higher median number of total conditions (adjusted for length of arrangement, and measured at the program design stage for ease of comparison). Moreover, without distinguishing between the type of program (GRA vs PRGT), fiscal conditions were much more numerous in CU members than in other fixed or flexible-type of exchange rate regimes. This also holds for GRA-supported programs only or PRGT-supported programs only (latter not shown), as the median number of fiscal conditions in CU members is higher than in non-CU member programs.

Total Number of Conditions, All Programs

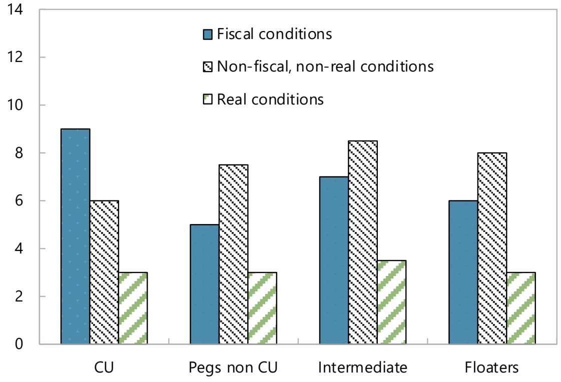
(Median)



Source: IMF MONA database.

Total Number of Conditions, All Programs

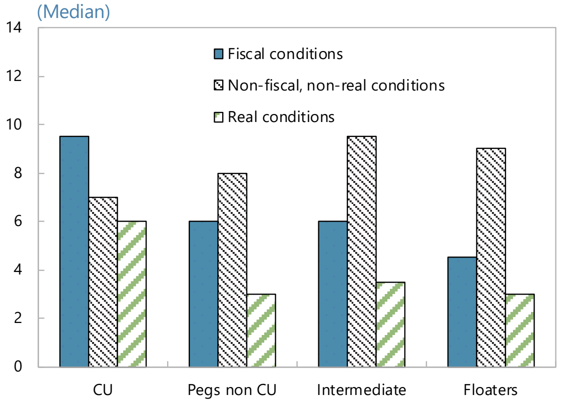
(Median)



Source: IMF MONA database.

Total Number of Conditions, GRA Programs

(Median)



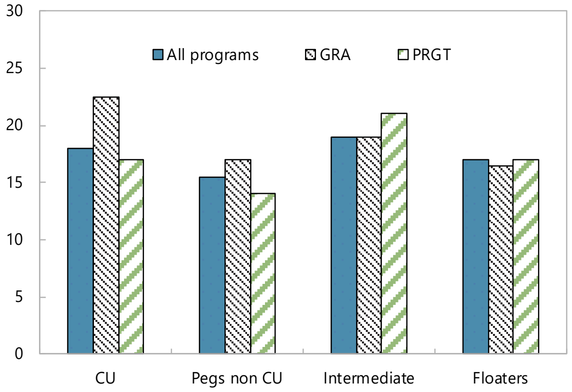
Source: IMF MONA database.

Box 4. Program Design and Conditionality (Cont'd)

The higher number of conditions (quantitative or structural conditionality) in CU member program design, especially in the GRA, reflects a greater focus on structural measures. This is logical as CU member programs do not pose conditionality on monetary of exchange rate policy. When breaking down the SBPA conditions into categories, structural fiscal conditionality in CUs consequently exceeds that of other non-CU member programs, while CU member programs are relatively heavy on 'real' (non-fiscal, non-financial) conditions but relatively 'thin' on others (monetary, financial sector, debt, external). The outsized emphasis on fiscal and 'real' conditions is especially strong in CU member programs under the GRA, compared to other GRA non-CU member programs, as the median number of fiscal and real SBPA conditions exceeds that in non-CU programs.

Total Number of SBPA Conditions, All Programs

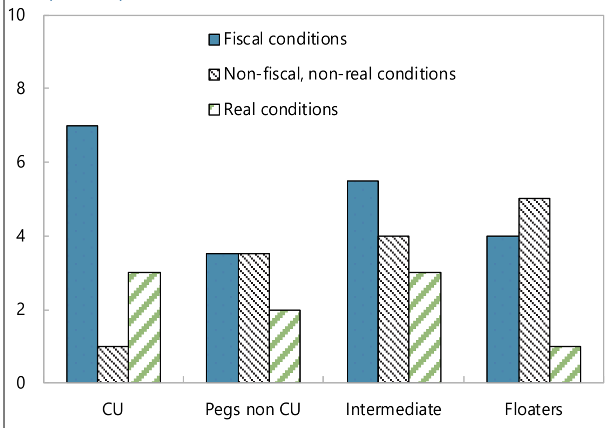
(Median)



Source: IMF MONA database.

Total Number of SBPA Conditions, All Programs

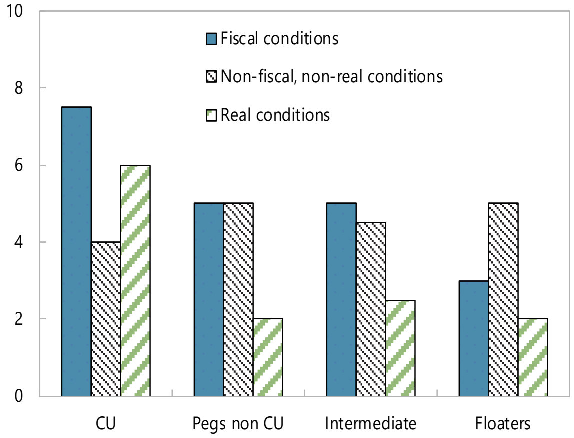
(Median)



Source: IMF MONA database.

Total Number of SBPA Conditions, GRA Programs

(Median)



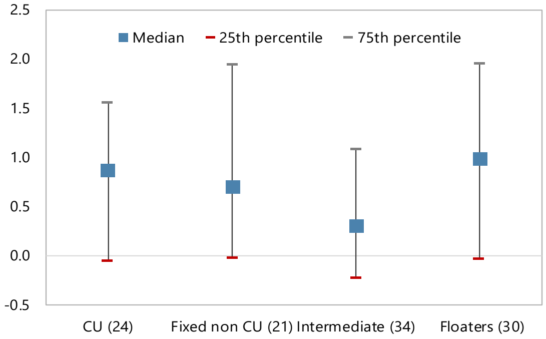
Source: IMF MONA database.

The reliance on a higher number of actions in the fiscal adjustment agenda is also evident when looking at the *planned* 3-year primary balance adjustment at program approval. For the sample of all programs, CU member programs envisage more primary balance adjustment compared to non-CU member programs, even if such adjustment is also large for floaters, and, differences in median adjustment across groups appear small. However, for GRA-supported programs, there is significantly more dispersion in the size of the planned adjustment between CU members and non-CU members, implying a much higher planned adjustment on average in CU members.

The findings outlined above regarding the burden placed on CU members, as well as evidence of more frontloading of fiscal adjustment in CU member programs, are largely confirmed by a robust econometric two-stage econometric approach, which is summarized in Box 5.

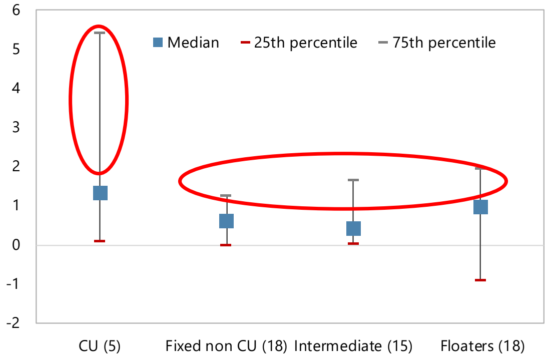
Box 4. Program Design and Conditionality (concluded)

3-Year Change in Primary Balance at Program Approval, All Programs



Source: IMF MONA database.

3-Year Change in Primary Balance at Program Approval, GRA Programs



Source: IMF MONA database.

Box 5. Program Adjustment and Objectives

This Box compares the impact of programs on growth in currency union members with that seen elsewhere.

Impact of Fiscal Adjustment on Growth

(Percent change in log of real GDP, T+3 from T)

	Fiscal Adjustment	Number of Fiscal Conditions
CU	-0.013* (0.007)	-0.014 *** (0.007)
NCU	-0.009** (0.004)	-0.002 (0.004)
Constants	0.175*** (0.046)	0.128 (0.034)
Observations	108	51 (GRA)
R-squared	0.378	0.577

Sources: IMF MONA database; and IMF staff calculations.
Note: Standard errors in parenthesizes. ***,**, * indicates statistically significant at 1, 5, and 10 percent, respectively. Fiscal Adjustment is measured as a change in the cyclically adjusted general government fiscal balance-to GDP ratio over program duration. Number of fiscal conditions is the total number of fiscal policy conditions over the program duration.

We use a robust econometric approach to analyzing this question. The analysis allows for program outcomes to differ in CU member countries for several reasons. A primary reason is that the adjustment process in currency union members could require larger changes in adjustment through quantities (output and employment) to facilitate the required relative price adjustment. In the face of frictions, economic theory would suggest such an outcome and the possibility that fiscal multipliers could be larger given the inability to (even partially) offset fiscal consolidation with expansionary monetary policy. While the program financing will attenuate the output cost of adjustment, as indicated in Box 4, in the absence of independent monetary and exchange rate policies, the necessary adjustment often requires heavier reliance on fiscal and structural measures by CU members. A second reason for differing growth outcomes is that countries enter programs with different initial conditions (such as the size of public debt or the external imbalances) and under different global conditions. Our empirical exercise controls for all such factors—domestic and global conditions, and program characteristics (such as program access or debt restructuring)—in a sample of 191 programs over the period 2002-16, which includes 41 programs of members of CUs.

We find that programs of CU members result in a larger impact on growth than programs of non-CU members. The results suggest that membership of a CU (absence of independent monetary policy) increases the negative impact on growth from either the size of the fiscal adjustment or the number of fiscal conditions. Thus, the fiscal multiplier appears larger in programs with members of CUs than in other programs. This difference is statistically significant and particularly large for GRA-supported programs. This larger growth impact can in turn raise the possibility of fiscal adjustment resulting in adverse debt dynamics by raising debt to GDP.

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August 28, 2017

PROGRAM DESIGN IN CURRENCY UNIONS—BACKGROUND NOTES

Approved By
Sean Hagan and Hugh Bredenkamp

Prepared by a staff team from both the Strategy, Policy, and Review Department (SPR) and the Legal Department (LEG) in collaboration with other departments. The SPR team was led by Nathan Porter and Greetje Everaert and comprised of Calixte Ahokpossi, Luiza Antoun de Almeida, Kareem Ismail, Xavier Maret, and Aleksandra Zdzienicka. The LEG team comprised of Wolfgang Bergthaler, Wouter Bossu, Kyung Kwak, Ioana Luca, Nadia Rendak, Gabriela Rosenberg, and Anjum Rosha. The paper also benefited from excellent research assistance provided by Jessie Yang and Zhongxia Zhang. Consultation between departments was facilitated through an interdepartmental contact group comprising:

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CONTENTS

CHARACTERISTICS OF DIFFERENT CURRENCY UNIONS ____ 2

CASE STUDIES: BURKINA FASO, GREECE, ST. KITTS AND NEVIS, AND DOMINICA ____ 7

A CONCEPTUAL FRAMEWORK FOR DETERMINING THE BOP NEED IN A CURRENCY UNION MEMBER ____ 10

CHARACTERISTICS OF DIFFERENT CURRENCY UNIONS

	CEMAC	**ECCU**	**EMU**	**WAEMU**
Composition	The CEMAC comprises six Central African countries: Cameroon, Central African Republic, Chad, Equatorial Guinea, Gabon, and the Republic of Congo.	The ECCU comprises eight Caribbean islands: Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and the Grenadines, but Anguilla and Montserrat are not IMF members since they are dependent territories of the United Kingdom.	The EMU comprises 19 countries: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.	The WAEMU comprises eight West African countries: Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo.
Exchange Rate Regime	The "CFA franc" has its own fixed exchange rate vis-a-vis the Euro and a separate acronym, with the Central African CFA franc to stand for "*Coopération financière en Afrique centrale*" (Financial Cooperation in Central Africa).	The *de jure* regime for the ECCU is a currency board. In practice, backing of the currency and demand liabilities has been close (but not equal) to 100 percent, hence the operation of a quasi-currency board.	The Eurosystem issues a reserve currency, the euro, which floats freely.	The "CFA franc" of the WAEMU has its own fixed independent exchange rate vis-a-vis the Euro and a separate acronym, with the West African CFA franc to stand for "*Communauté Financière d'Afrique*"

	CEMAC	**ECCU**	**EMU**	**WAEMU**
Exchange Rate Regime (concluded)	Prior to the euro's introduction, the CFA was pegged to the French franc.			(Financial Community of Africa). Prior to the euro's introduction, the CFA was pegged to the French franc.
Trade integration	Customs union in place but full implementation has been delayed.	Customs union in place for most sectors of the economy, but tariffs are not fully harmonized.	EU common market	Customs union (UEMOA) established between 1996 and 2000 but issues remain (Goretti and Weisfeld, IMF WP 08/68)
Type of Currency Union[1]	"Centralized", characterized by having only one regional central bank—no national central banks exist. The BEAC (the central bank of the CEMAC) is headquartered in Cameroon, and each has national directorates in each member country. National branches are not autonomous and	"Centralized", characterized by having only one regional central bank—no national central banks exist. In the ECCU, the regional central bank (ECCB) is headquartered in Saint Kitts but maintains agency offices in the other seven islands.	"De-centralized". In a decentralized currency union, central banks at national level coexist with the European Central Bank (ECB), which is headquartered in Germany. National central banks maintain their individual balance sheets, and are integral part of the Eurosystem. The Eurosystem (ECB and NCBs) is governed by the decision-making bodies of the ECB.	"Centralized", characterized by having only one regional central bank—no national central banks exist. The BCEAO (the central bank of the WAEMU is headquartered in Senegal, and each has national directorates in each member country. National branches are not autonomous and serve essentially as

[1] As defined in the *Balance of Payments and International Investment Position Manual, Sixth Edition* (BPM6), Appendix 3.

	CEMAC	**ECCU**	**EMU**	**WAEMU**
Type of Currency Union (concluded)	serve essentially as local quarters for the regional central bank. they help implement regional policies and provide analysis of local economic conditions to support regional policy-making.			local quarters for the regional central bank. they help implement regional policies and provide analysis of local economic conditions to support regional policy-making.
Reserve pooling	French Treasury acts as guarantor	ECCB maintains a peg to the U.S. dollar through a quasi-currency board arrangement. ECCU members pool foreign exchange to a common reserve pool. ECCB must maintain their contribution to pooled official reserves at no less than 60 percent of its demand liabilities	Reserves are partially transferred to ECB, part remain on national central bank's books. Upon creation of the ECB, member national banks contributed to the ECB reserves [in relation to the ECB capital key]. Given the euro's status as a reserve currency and its fully floating nature, reserve coverage and/or reserve buildup are not considered explicit objectives	French Treasury acts as guarantor

	CEMAC	**ECCU**	**EMU**	**WAEMU**
Repatriation requirements	Yes, there are repatriation requirements.	In the ECCU, these vary country by country.	No repatriation requirements	Yes, there are repatriation requirements.
Access by the government to direct monetary financing or stability support	Advances exist. Limits on holdings of T-bills by the central bank.	In the ECCU, only through temporary advances to the government (at 5 percent of revenue over the preceding three years). Limits on holdings of T-bills by the central bank.	No. The ECB is prohibited from providing monetary financing to sovereigns. The ESM and the EFSM can provide support under conditionality.	No. Limits on holdings of T-bills by the central bank.
Emergency liquidity provision to banks	not part of standard toolkit	The ECCB has the power to provide liquidity assistance to financial institutions in the event that one of its members is in danger of disruption.	ELA assistance is provided by NCBs, under the control of the ECB Governing Council.	not part of standard toolkit
Decision Making Bodies of the Central Bank	The CEMAC Monetary Policy Committee is presided by the governor of the central bank and	ECCB Monetary Council includes the finance ministers of all eight member governments.	Independent central bank, with decision making done by the Executive Board of the ECB and the Governing Council of the ECB. These two bodies govern the Eurosystem.	The Conference of Heads of States and Governments sets the overall directions of monetary, exchange rate, and financial sector policies

	CEMAC	**ECCU**	**EMU**	**WAEMU**
Decision Making Bodies of the Central Bank (concluded)	includes 14 other members, two for each member country (one of which is the Director on the national directorate of the BEAC) and two for France.			but also has the final responsibility for their implementation. From an operational viewpoint, the BCEAO defines and implements monetary and exchange rate policies while the responsibility for the stability of the financial system is settled between regional (BCEAO/Banking Commission) and national authorities (Ministry of Finance). The Monetary Policy Committee is composed of the BCEAO Governor, Deputy Governors, representatives of each member states, one member in charge of CFAF convertibility, and other members nominated by the Council of Ministers. convertibility, and other members nominated by the Council of Ministers.

CASE STUDIES: BURKINA FASO, GREECE, ST. KITTS AND NEVIS, AND DOMINICA

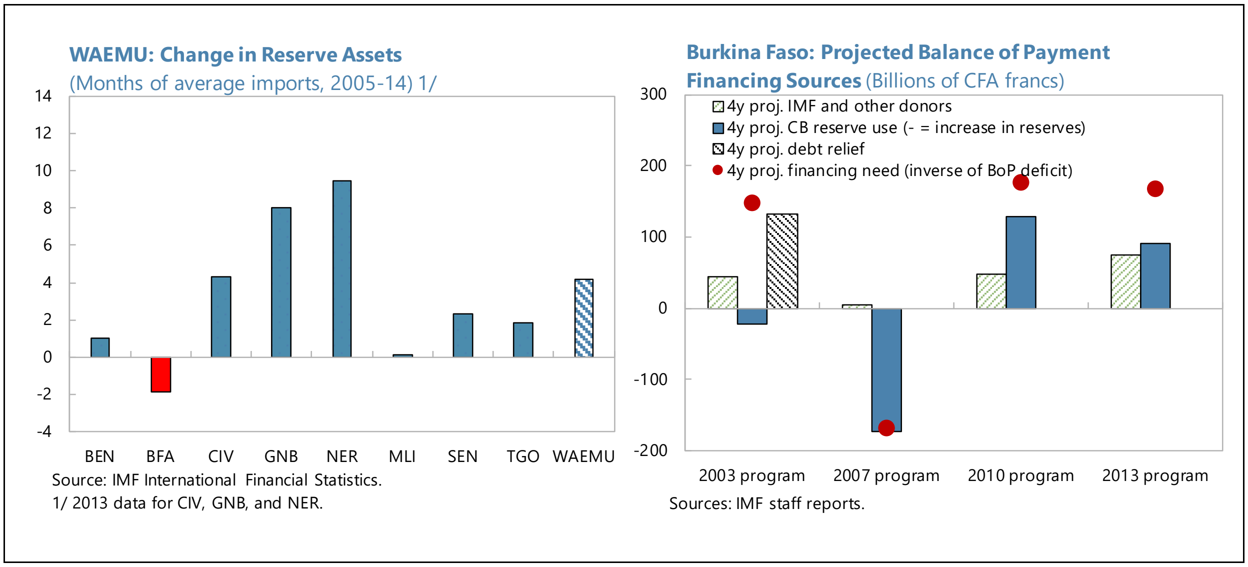
This background note outlines program design in four currency union cases, which present a characterization of selected issues confronted in these programs. The cases highlight that members of CUs can draw on pooled reserves, but this may affect overall reserve coverage of the union, and that liquidity needs for both governments and the banking sector have been at the core of balance of payments deficits, even if not always fully recognized as such in statistical tables.

1. Burkina Faso—*the limited merits of drawing on pooled reserves*

- **Burkina Faso has had a range of consecutive IMF supported programs**, with arrangements approved in the 1990s, 2003, 2007, 2010, and 2014. Programs generally supported the country's growth and poverty reduction agenda, while promoting structural reforms in a range of areas.

- **While Burkina Faso was affected by a number of shocks over this period, it continued to be a negative drag on the WAEMU region's reserves**. While WAEMU reserve coverage increased over the past decade by about 4 months of imports, Burkina Faso contributed negatively to reserve accumulation over this period, as reported in IFS statistics, losing close to 2 months of import coverage. Most losses were incurred after 2009.

- **Programs were not designed to sufficiently address national imbalances and restore external viability**. While the 2003 and 2007 programs projected a positive contribution to regional level reserves, under the 2010 and 2013 programs, programmed reserve drawdown exceeded Fund, bilateral, and multilateral financing. This implied the program relied on a continued drain on regional reserves, which indeed materialized, reflecting that either policies were unlikely sufficiently tight or financing insufficient to cover 'above the line' balance of payments deficits. Hence, program design insufficiently took into account the coordination problem from relying on pooled reserves.



WAEMU: Change in Reserve Assets
(Months of average imports, 2005-14) 1/

Source: IMF International Financial Statistics.
1/ 2013 data for CIV, GNB, and NER.

Burkina Faso: Projected Balance of Payment Financing Sources (Billions of CFA francs)

Sources: IMF staff reports.

2. Greece's 2010 SBA—*the role of liquidity support to banks and the sovereign in BoP needs*

- **The spillovers of the government liquidity crisis to bank liquidity were dealt with through ECB financing, but not included as below-the-line financing.** The ECB provided specific sources of support (e.g. through waivers on minimum credit rating requirements on (Greek) instruments used in the monetary policy operations (collateral for refinancing), and later through full allotment auctions which implied excess liquidity creation for the Euro system as a whole in order to address impaired interbank markets and impaired monetary policy transmission). In the absence of such external liquidity provision to the domestic banking system, liquidity tightness in Greece would have required and resulted in stronger and potentially more disruptive economic adjustment (e.g. sharper import compression and/or stronger fiscal consolidation). As a substitute for adjustment, this may well have been considered a critical source of financing to the Greek program, with a reflection of such ECB support to the domestic banking system made 'below the line.'

3. St. Kitts and Nevis' 2011 SBA—*the role of liquidity support to banks in BoP needs*

- **St. Kitts and Nevis' 2011 SBA aimed to restore fiscal sustainability and financial stability, and created a special banking reserve fund.** A key program component included a debt restructuring operation to restore fiscal sustainability and in so doing also resolve bank-sovereign links. As such restructuring caused uncertainty about possible deposit flight—which could create pressures on domestic liquidity (or more likely on foreign reserves). To address this, the program financed the creation of a Banking Sector Reserve Fund (BSRF) to buffer against liquidity needs. The creation of this BSRF also required large front-loading of the Fund-supported program.

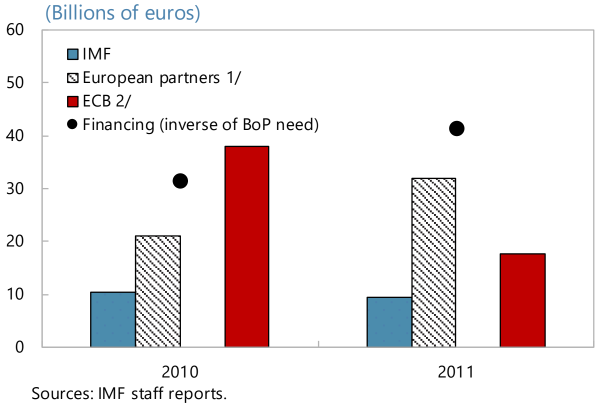
  The balance of payments deficit in the program tables did not clearly include those related to the BSRF. Balance of payments needs were financed through limited reserve drawdown, IMF financing, and residual financing to be met through debt restructuring. Financing by the IMF for the BSRF was mentioned below-the-line in the balance of payments table, but was not numerically reflected as contributing to the balance of payments deficit, or to its financing. While the treatment was motivated by the precautionary nature of the BSRF and the need for clear communications about the financing needs at the time of a debt restructuring, an alternative presentation would have reflected a buildup of deposits at the non-resident ECCB (which could have been recorded above the line), and financed by the exceptional Fund financing (which may have been included below the line).

4. Dominica's 2002 SBA—*the role of ECCB support to the sovereign*

- **Dominica's 2002 SBA responded to external shocks, rising public debt and an economic downturn.** Weaker macroeconomic outturns and policy slippages, however, caused the program to go off-track, and it was subsequently modified and extended, but required additional financing for 2003. Such financing included IMF and other official support, along with a US$1 million loan (0.3 percent of GDP) from the ECCB to help finance the larger fiscal balance.

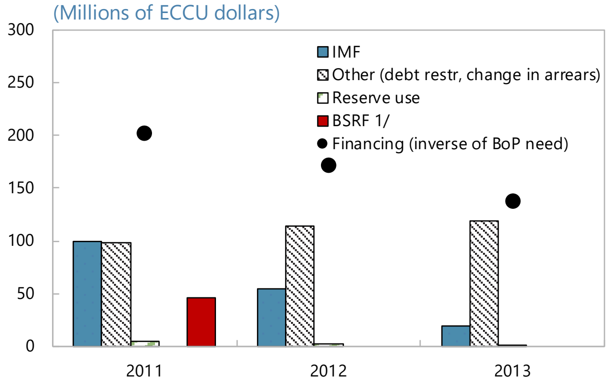
- **The exceptional balance of payments "below the line" financing correctly included this fiscal support.** Being a loan from a non-resident, the regional central bank, this was included in the balance of payments, presented as helping to fill the financing gap. Such treatment contrasts with the recording of advances from the regional central bank (in African monetary unions) or the treatment of similar government support from the ECCB to the government of Antigua and Barbuda in 2010 to deal with deposit outflows and bank recapitalization in one bank (Stanford Group) as *domestic* fiscal financing.

Greece: 2010 SBA Financing Sources
(Billions of euros)



Sources: IMF staff reports.
1/ Greek Loan Facility, EFSF.
2/ Change in Target 2 balances. These were reported above the line.

St. Kitts and Nevis: 2011 SBA Financing Sources
(Millions of ECCU dollars)



Sources: IMF staff reports.
1/ Not contributing to balance of payments deficit.

A CONCEPTUAL FRAMEWORK FOR DETERMINING THE BOP NEED IN A CURRENCY UNION MEMBER

This background note lays out the treatment of balance of payments needs in the context of countries in currency unions (CU). Certain features of currency unions—including the non-resident nature of the union-level central bank (CUCB) and the interdependence created by membership in a union—affect the nature of external support and thus the balance of payments need. In particular, CUCB support provided on its "own account" to support a program is likely exceptional program financing.

1. **The existence of a balance of payments need is a core requirement for the Fund to provide access to its general resources.** The Articles of Agreement stipulate three forms of balance of payments needs under which the Fund can lend. These include a need because of: (i) a *member's balance of payments* (i.e., where a member has or is expected to have a balance of payments deficit); (ii) a *member's reserve position* (i.e., where reserves are inadequate); and (iii) *developments in reserves* (i.e., where, for example, a member that issues a reserve currency is facing a temporary liquidity problem). These balance of payments criteria are exclusive and alternative—no other form of need can justify a member drawing on Fund resources—but any one of them is sufficient. The need identified in program documents could be either actual or prospective identified through the baseline (for a drawing program) or potential, based on a downside scenario for an arrangement approved on a precautionary basis.[2]

2. **Given this**, **program documents must clearly demonstrate the existence of a balance of payments need to substantiate the basis for the Fund to provide financing to its members**. For program purposes, the presentation of balance of payments needs involves a clear separation of autonomous transactions from those designed to fill a balance of payments gap.[3] This *analytical* presentation of the balance of payments distinguishes autonomous transactions from use of

[2] With respect to concessional financing from the PRGT, the above analysis of a balance of payments need applies to the Standby Credit Facility and Rapid Credit Facility. However, regarding the Extended Credit Facility, members may receive financing under this facility if they have a "protracted balance of payments problem" at the time of approval of the arrangement (Section II, paragraph 1(b)(2) of the PRGT Instrument) and a member can have a protracted balance of payments problem even if it does not have a balance of payments need as defined under the Articles of Agreement. In determining whether a protracted balance of payments problem exists, the Fund examines the components of the balance of payments rather than the overall balance of payments position along with other indicators. (for more details see *Staff Guidance Note on the Use of Fund Resources for Budget Support,* EBS/10/44, 3/24/2010) Since the distinction between "balance of payments need" and "balance of payments problem" is not germane to the discussion in this paper, the terms are used interchangeably in this paper.

[3] For statistical reporting purposes, countries typically follow the *standard* presentation—the international benchmark—but this presents changes in reserve assets and closely related items (including exceptional financing) as part of the financial account, making it more difficult to analyze and present the balance of payment deficit and its financing. Therefore, the Manual also outlines an *alternative* analytical presentation which facilitates a distinction between reserves and related items (including exceptional financing transactions) and other transactions, by reorganizing the standard presentation, based on an analytic construct but not on precise criteria.

reserves and other exceptional financing (including from the Fund) to meet the balance of payments gap.[4]

3. Inaccurately specifying the balance of payments need may threaten a program's viability. The purpose of a member's Fund-supported program is to facilitate adjustment so that the country no longer needs to rely on reserve drawdown, exceptional financing, or so that the union can restore buffers to prudential levels with respect to that member by the end of the program.[5] That is, it allows the member to resolve its balance of payments problem within the program period and, where relevant, the ability to (re) access capital markets within a timeframe and on a scale that would enable the member to meet its obligations due to the Fund. Hence all balance of payment flows need to be included, and the nature of these flows needs to be carefully separated between exceptional or autonomous (underlying). The failure to correctly separate exceptional from autonomous flows could result in countries being unable to exit program support even after completing their programmed policy adjustments. Overestimating exceptional inflows may similarly risk program viability by ultimately requiring harsher adjustment than expected.

4. Thus, designing a program of members of currency unions requires a careful assessment of two issues: (i) the residency of financing institutions; and (ii) the exceptional nature of their financing. In the following, we will first elaborate on the residency of the central banking institutions (and thus whether its transactions with the member should be accounted for in the BOP). Second, we will present key criteria to help distinguish and assess when financing takes on an exceptional nature. Third, we also discuss the nature of the balance of payments need when it reflects inadequate union-level reserves.

Incorporating *All* Balance of Payments Flows—Residency of the CUCB

5. CUCBs are organized alongside two different models.

- **In "centralized"[6] CUs** (e.g., ECCU, WAEMU, CEMAC), the CUCB consists of only one legal entity, even though there may be branch offices present in member countries that assist in the operational implementation of union-level policies. However, such branches have no separate legal status, and hence no own-capital or loss-bearing capacity. CUCB transactions and those of their branches are therefore external.

[4] The sixth edition of the *Balance of Payments Manual* identifies *exceptional financing* (see Appendix 1), as that which "*brings together financial arrangements made by the authorities (or by other sectors fostered by authorities of an economy to meet balance of payments needs*".

[5] In the context of a currency union, a balance of payments need for a member could arise from a CU-wide shortfall in reserves or a member-specific shortfall in buffers aimed at addressing contingencies specific only to that member.

[6] As defined in the *Balance of Payments and International Investment Position Manual, Sixth Edition* (BPM6), Appendix 3.

- **In a "decentralized" CU** (eg., EMU), in addition to the CUCB, national central banks (NCB) exist and are separate legal entities, resident in the relevant country.[7] As separate legal entities, NCBs have their own balance sheets and capital, and operations by the NCB that are initiated by the NCB are domestic transactions and are backed by the NCB's own capital (e.g., ELA). As in centralized CUs, CUCB transactions with a member country are external.

6. **CUCBs are not residents of their members.** The Balance of Payments Manual establishes that a union-level central bank is not resident of any of the union's members, but is resident of the union (BPM6 Manual Appendix 3). The analytical rationale for this treatment bears close similarity to why multilateral institutions including the Fund or regional development banks are considered non-resident to all of their members—BPM6 considers an international organization, including a CUCB, to have "an economic territory in its own right."[8] In addition, by their establishment through an international agreement (typically, a Treaty), CUCBs are legal entities that are not incorporated nor registered in any specific member country. The mandate of a CUCB is to conduct monetary and exchange rate policy on behalf of *each* of its members. The joint responsibility of all the members for the CUCB—including through decision-making, governance, and loss-bearing capacity—indicates that the "center of predominant economic interest" lies with *all* its members. Hence, as CUCBs are represented and backed collectively by its members, no country in a CU can claim the CUCB as a resident.

7. **As a result, "own account" flows between the CUCBs and a member country are of a cross-border nature**.

- **In a "centralized" CU**, "own account" liquidity operations of the CUCB to a member take place exclusively through the non-resident CUCB. Local CB branches may help channel funding from the CUCB to the member but act merely as intermediaries, as they do not have an independent balance sheet and their loss bearing falls on the union at large.

- **In "decentralized" CUs**, financial flows between the CUCB (e.g. ECB) and the member similarly can have a cross-border nature. Hence, liquidity provision by the central banking system of the union to the banks of the member would have a direct balance of payments impact if liquidity demand is ultimately associated with cross-border transactions. However, operations by the NCB that are supported by the NCB's own loss-bearing capacity (such as Emergency Liquidity Assistance in the EMU), are considered a resident-to-resident transaction and hence do not directly affect the balance of payments unless liquidity met by

[7] In the case of the EMU, the CUCB is the ECB. The ECB, together with NCBs together form the Eurosystem.

[8] BPM6 Chapter 4: "The economic territory of an international organization … consists of territorial enclave(s) over which the organization has jurisdiction. These enclaves are clearly demarcated land areas or structures that the international organization owns or rents and uses, and that are formally agreed on with the government of the territory, or territories, in which the enclave(s) are physically located. Each international organization is an economic territory in its own right, covering operations from all its locations." And "A central bank to a group of economies (including currency union central banks) is an example of an international financial organization."

ELA is ultimately associated with cross-border operations.[9] In the case of the EMU during the period 2010-12, TARGET2 balances proxy the extent to which NCBs rely on Eurosystem liquidity. Thus, flows underlying TARGET2 transactions should be reflected in the BOP with some considered autonomous, while others could be exceptional financing to resolve a BOP need.

Distinguishing Autonomous from Exceptional Balance of Payments Flows

8. **Correctly identifying the financing gap also implies clearly distinguishing whether financing transactions are autonomous or exceptional**. Private flows are almost exclusively autonomous in nature, while official bilateral flows can be exceptional if they are aimed primarily at financing a balance of payments gap. This distinction also needs to be made for financing from the CUCB. While doing so will inherently contain an element of judgement, the following principles aim to guide such distinction.

- **Duration**. Autonomous transactions are likely to reflect regularly used liquidity operations, e.g. in response to temporary shortfalls of liquidity that are expected to be reversed relatively quickly. Exceptional support likely involves covering sustained or persistent shortfalls. The underlying cause of such needs could be resident flight (indicated by persistent deposit withdrawals) or a loss of market access and inability to rollover debt (by either the public or private sector). In such cases, central bank support to the financial system (and where relevant, sovereign) should be considered exceptional. Some examples:

    - Persistent reliance by one or a few countries in the EMU on Eurosystem liquidity facilities at the time where other EMU members persistently register surplus liquidity.

    - Persistent or rising overdraft balances of some CEMAC countries from BEAC.

- **Common application**. Autonomous transactions are likely to reflect those policies of liquidity provision that are applied uniformly to all members of the CU. However, specific exceptions made to accommodate one or selected members of the CU would typically be considered exceptional sources of liquidity provision. Examples include:

    - The loan granted by the ECCU to Dominica in the context of its 2002 SBA program (Background Note II).

    - The ECCB and CEMAC frameworks allow for credit allowances to governments up to a ceiling in relation to their revenues and by CU wide reserve coverage of liabilities.

[9] The moment the liquidity provided by the NCB is used in a transaction with a non-resident, (e.g the payment to another member in the currency union), this transaction will be registered in the balance of payments (e.g such payment settlement will appear as an increase in the TARGET2 balance of the corresponding non-resident NCB and a decline in the TARGET2 balance of the local NCB).

This financing could also be considered exceptional balance of payments support if it exceeds normal benchmarks.[10]

- o ECB financing provided via discretion in applying union-wide policies (e.g. collateral requirements of Greek debt) could be considered exceptional.

- **Intent of the liquidity provision.** Autonomous transactions are likely those that result from regular market functioning and operations. However, liquidity provision in response to emergency situations may reflect the character of exceptional lender of last resort financing. Examples:

  - o The ECB response to the fragmentation of financial markets in the EMU, the latter of which hampered monetary policy transmission and which was reflected in some agents (e.g. banks) effectively being cut off from normal market-pricing mechanisms. As such, the intent of the full-allotment fixed rate auctions was to provide liquidity to banks in those members where market forces no longer could provide such liquidity, and where liquidity provision was needed. This, together with the expansion of the collateral base and the provision of long-term financing, facilitated provision of liquidity for banking transactions that are settled in TARGET2 accounts. The provision of ECB liquidity under the facilities noted above during 2010-12 was exceptional and thus gives rise to below the line funding. [11]

  - o The ECCB can only provide liquidity support to banks if the absence of this support would result in financial disruption for the member. Thus, such support is not expected under normal circumstances and any change in net liabilities of residents vis-à-vis the ECCB arising from such transaction would be considered as exceptional financing.

[10] The ECCB has strictly maintained these principles in extending credit, with no member allowed to draw more than the credit allocation allowed under the framework. However, WEAMU and CEMAC has had instances of repeatedly breaching their framework and members can draw down on pooled reserves. This together with the moral hazard from the French guarantee on operational accounts at its treasury have meant that the framework was disregarded under normal conditions.

[11] During 2010-12, "TARGET2 liabilities … increased sizably for some NCBs. This is because their banking systems have faced payment outflows in euro which have not been matched by payment inflows in euro […]. However, the money which a bank can use to conduct payments needs to be offset by a compensating inflow. In a context of impaired interbank money markets and the non-standard monetary policy measures introduced by the ECB as a result, compensation comes from central bank liquidity […]. This has been reflected in an exceptional increase in Eurosystem liquidity provision during the crisis. […] The large increase in the TARGET2 liabilities of some countries' NCBs during the financial crisis is thus a reflection of funding tensions in those countries' banking systems and the Eurosystem's accommodation of the ensuring liquidity needs. Accordingly, the very high level of net cross-border payment flows reflects the extraordinary support provided by the Eurosystem to ensure the effectiveness of the single monetary policy." ECB (2011).

Reflecting Balance of Payments Problems Stemming from a Member's External Viability Issues

9. A balance of payments problem can arise if the member needs additional buffers, either for self-insurance or to address external viability risks.

- **A balance of payments problem can arise from the need to address external viability risks, and this needs to be transparently reflected in program documents**. Focusing only on the balance of payments deficit of an individual currency union member may leave the CU as a whole short of adequate reserve coverage and may jeopardize the prospects of member programs successfully restoring external viability. The jeopardy would arise from the union having insufficient reserves to defend the peg or prevent disorderly movements in the currency. This implies that more adjustment may be needed in the members with a Fund arrangement to restore the viability of the union, and hence the external viability of the borrowing member. The individual member country contributions to addressing union-level viability concerns (in addition to their own balance of payments deficits) should be reflected in Fund documents . Regional reserve coverage (in US$ billion or other denominating reserve currency and in percent of relevant metrics) should be reported as a memorandum item in the medium-term balance of payments table.

- **Other buffers.** The member may need to mitigate against risks such as the need for further resources to recapitalize banks or deal with other liquidity pressures (e.g., programs in Ireland, Cyprus, and St. Kitts and Nevis). These buffers should be clearly accounted for in the tables under exceptional financing.

INTERNATIONAL MONETARY FUND

PROGRAM DESIGN IN CURRENCY UNIONS—POLICY FRAMEWORK OF THE EUROPEAN UNION INSTITUTIONS

February 1, 2018

Approved By
Sean Hagan and Hugh Bredenkamp

Prepared by IMF staff.

POLICY FRAMEWORK OF THE EUROPEAN UNION INSTITUTIONS

Following the issuance of the Board paper on "Program Design in Currency Unions" (SM/17/237), staff has continued a dialogue with the European Union authorities over aspects of their policy framework that are germane to the topic of the paper. In light of these discussions, this supplement elaborates further on the governance of EU institutions, the ECB's monetary policy framework and operations, the role of Target 2 in the Eurosystem, and relevant aspects of the supervisory framework within the banking union. This supplement does not affect the staff's policy proposals in SM/17/237.

1. **The legal independence of the ECB.** While the staff paper emphasizes that the proposed approach regarding policy assurances from union-level institutions would in no way infringe upon the legal or operational independence of such institutions, in discussions with staff the euro area authorities highlighted the legal constraints which their institutions—notably the ECB—must observe. In particular, the euro area authorities have emphasized the following:

- **The Treaties governing the EU and the euro area assign specific responsibilities to its supra-national bodies and explicitly enshrine the independence of some of those bodies.** The union-level authorities pursue common policies such as monetary, supervisory, or competition policy which cannot be altered with respect to an individual Member State without affecting the independent mandates of the respective institutions to provide a consistent legal and institutional framework for all 28 EU members as enshrined in the EU Treaties. Those common policies are outside the direct and indirect control of the respective country authorities.

- **In this context, the ECB's independence is a cornerstone for the effectiveness of the ECB's mandate.** Article 130 of the Treaty on the Functioning of the European Union (TFEU) contains a double prohibition to safeguard this independence. First, the ECB/Eurosystem is prohibited from seeking or considering instructions from any other body, inside or outside the union. Second, EU institutions and the governments of EU Member States undertake not to seek to influence the members of the ECB's decision-making bodies in the performance of their tasks. Independence enables the ECB to define and implement a "single monetary policy" in pursuit of its primary objective of maintaining price stability in the euro area without any adverse influence from the various national decision-makers that exercise national or shared sovereignty in several policy domains within the euro area.[1]

- **The ECB also enjoys independence in the exercise of its supervisory tasks.** This is reflected in Article 19 of the Council Regulation 1024/2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions. The nature of the ECB's implementation of supervisory policies gives the ECB scope, when deemed necessary, to voluntarily provide information related to its supervisory policies, with or without emphasis on selected jurisdictions. Indeed, micro-prudential policies have played a central role in adjustment programs within the euro area. The ECB stressed, however, that it reserves the right to modify the initially defined policy approach should it see a need to do so, for example, in light of changing circumstances. Any ECB decision in the field of supervision, including modalities for the communication of policy intentions in the area of micro-prudential supervision, must be determined in line with ECB decision-making procedures.

- In view of the above, the provision by EU supra-national bodies of any type of policy assurances has to be in line with the requirements of their legal framework—notably legal independence.

2. The monetary policy framework of the Eurosystem. In discussing the circumstances under which the Fund would seek assurances regarding actions by union-level institutions in support of a member's program, the staff paper draws a distinction between actions that would have effects limited to a specific country (certain supervisory actions, for instance) and those that would have union-wide impact. The euro area authorities have emphasized that there are various aspects of the ECB's operational framework that ensure adherence to the principle of a single (union-wide) monetary policy, and highlighted the following points:

- **In the Eurosystem—consisting of the National Central Banks (NCBs) of the euro area countries and the ECB—decisions on monetary policy are made at the level of the Governing Council of the ECB.** The common monetary policy is generally implemented at the level of the individual NCBs, according to the decisions made and guidelines laid down by the Governing Council and under coordination by the ECB.

[1] The Court of Justice of the EU has confirmed that, when implementing its monetary policy, the ECB/Eurosystem must be allowed "broad discretion" so as to ensure that it fulfils its mandate under the Treaties to define and conduct a "single monetary policy."

- **The Governing Council of the ECB formulates monetary policy for the euro area as a whole and decides on all related implementation modalities**.[2] In particular, the Governing Council agrees on the common collateral and counterparty eligibility framework and decides on non-standard monetary policy measures such as Fixed Rate Full Allotment (FRFA) in liquidity-providing operations,[3] and asset purchase programs, the Eurosystem's form of quantitative easing (QE).

- **The ECB's monetary policy operations are conducted only with financially sound euro area credit institutions against adequate collateral.** The Governing Council ensures a level playing field, i.e. that every credit institution within the euro area can receive central bank liquidity on the same terms, including the definition of eligible collateral for monetary policy operations. The ECB modified the collateral requirements during the euro area financial crisis in line with emerging needs to ensure the smooth functioning of the monetary policy transmission mechanism. The authorities highlighted in this context that the waiver of rating requirements for collateral is a rule, not a discretionary measure, and it applies to any euro area government that meets the criteria (i.e. if the government is under a program and on track with it, then rating requirements are waived for assets issued or guaranteed by it) and to any monetary policy counterparty (i.e. any counterparty can use as collateral any asset issued by a government to which a rating waiver applies). The Eurosystem does not provide credit to any government body, as such operations are prohibited as constituting monetary financing, in accordance with Article 123 of the TFEU.

- **The Governing Council conducts monetary policy in pursuit of its mandate under EU law to maintain price stability in the euro area as a whole.** ECB monetary policy decisions are based on euro area wide developments and the euro area outlook for price stability in the medium term, not on developments in any specific country. This implies that the setting of monetary policy cannot be changed for the benefit of a single country or be applied only to a single country.[4]

- **There is also no leeway for an NCB to deviate from the single monetary policy setting.** The balance sheet of an NCB largely reflects the implementation aspects of the single monetary policy instruments (lending operations, asset purchases) and does not provide any leeway in conducting monetary policy. Also, non-monetary policy activities of NCBs are

[2] The Governing Council consists of the governors of the NCBs participating in the euro area together with the six Executive Board members of the ECB. The members of the Governing Council are mandated in their personal capacity and do not represent a country. The decision-making of the Governing Council takes place in full independence.

[3] Under FRFA, counterparties can receive at a fixed main refinancing rate as much central bank liquidity as they wish against eligible collateral. FRFA does not apply to Targeted Longer-term Refinancing Operations (TLTROs) for which counterparty-specific limits are set.

[4] The authorities stressed that, while monetary policy can have a balance of payments impact (see next section), it is never implemented by the ECB with the intention to target balance of payments movements or needs, as these are not part of the ECB's mandate.

subject to decision and guidelines laid down by the Governing Council and monitoring by the ECB, in particular to ensure that non-monetary policy activities do not interfere with the objectives and tasks of the Eurosystem.

- **The costs, gains and risks from the single monetary policy can be shared among the Eurosystem on the basis of a Governing Council decision.** Monetary policy operations are booked on the balance sheet of the NCB or the ECB conducting the transaction. The reserves held by the banking system are booked on the balance sheet of the NCB where the respective credit institution is located.[5] The income accruing to the NCBs in the performance of the monetary policy lending operations is pooled and then distributed to the NCBs in line with their capital key.[6]

- **Based on national mandates, and not as part of the single monetary policy of the Eurosystem, NCBs may exceptionally provide emergency liquidity assistance (ELA) to credit institutions that are in need of liquidity.**[7] ELA is understood as the provision of central bank money to individual solvent financial institutions that are facing temporary liquidity problems.[8] The provision of ELA must be sufficiently collateralized, although the standards (e.g. regarding collateral quality and haircuts) may differ from those applied in monetary policy operations.

- **While the responsibility for the provision of ELA lies at the NCB level, the Governing Council can object to any such operation if they find that it would interfere with the Eurosystem's objectives and tasks.** This could, for example, be the case if ELA was deemed to interfere with the price stability objective or the definition and implementation of the (single) monetary policy in the euro area. ELA is recorded on the balance sheet of the respective NCB. Any costs and risks arising from the provision of ELA are incurred by the NCB concerned.

3. TARGET2 and the balance of payments of euro area countries. The staff paper describes the general approach the Fund would take, for program purposes, to assess the balance of payments need of countries that are members of currency unions. The euro area authorities have reiterated that a number of considerations would need to be taken into account when applying this approach in the particular context of the euro area. They have made the following points:

[5] Credit institutions interact with the NCB with which they have an account. The ECB does not hold monetary policy accounts of credit institutions.

[6] The Eurosystem is obliged to publish a weekly consolidated financial statement.

[7] The complete ELA agreement can be found on the ECB website: https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf?23bb6a68e85e0715839088d0a23011db.

[8] This may be the case if a credit institution does not have sufficient eligible collateral at its disposal to participate in monetary policy operations or is suspended/limited/excluded from these operations, e.g. on the grounds of prudence from an ECB risk management perspective.

- **TARGET2—a real-time payment system for processing large-value, euro-denominated payments in central bank money (i.e. banking system reserves)—is integral to the monetary union, as it ensures that the liquidity of banks held with the Eurosystem is fully fungible across euro area member countries.** As long as all payments in central bank money are made between domestic accounts, only accounts at the NCB concerned are affected. The TARGET balance of that NCB vis-a-vis the ECB will remain unchanged. If cross-border central bank money payments are made in the euro area, the accounts of two NCBs will be affected and accordingly also their respective TARGET balances vis-à-vis the ECB.

- **In other words, the Eurosystem's monetary policy operations may have an impact on a Member State's balance of payments via TARGET balances only if the injected liquidity is used for cross-border payments.** At the time of liquidity provision via credit operations (both Eurosystem refinancing operations and ELA), the liquidity provided by the NCB is credited to the account at the NCB held by a bank domiciled in the NCB's jurisdiction. No cross-border payment occurs and TARGET balances are not affected. Only if banks transfer these funds abroad (on their own behalf, e.g. to repay cross-border loans, or on behalf of customers) may changes in TARGET balances arise. In contrast, unconventional monetary policy operations such as the Asset Purchase Program (APP) can be associated with direct cross-border payments upon implementation. NCBs purchase securities (with Governing Council-decided volumes and conditions), which can affect TARGET balances to the extent that the counterparty in the transaction with the NCB is a non-domestic one. Subsequent portfolio rebalancing by underlying sellers can also give rise to cross-border payments and changes in TARGET balances. Purchases of securities under the APP by the ECB itself may also have cross-border impacts.

- **In the "standard" presentation for statistical reporting under BPM6, all cross-border flows of central bank money, as reflected in changes in TARGET balances, are recorded in the balance of payments (BoP) of euro area countries.**[9] These flows appear as part of "other investment" in the financial account under the item "other investment—national central bank."[10] According to BoP accounting (equation 1, below), a euro area country's current account (CA) deficit (surplus) with the rest of the world is matched by private and/or official net financial inflows (outflows) denoted by FA, where the latter include changes in

[9] A detailed explanation of TARGET balances can be found in The Eurosystem's asset purchase programme and TARGET balances (2017), ECB Occasional Paper No. 196, Jens Eisenschmidt, Danielle Kedan, Martin Schmitz, Ramón Adalid and Patrick Papsdorf.

[10] From the Fund's perspective, under the "analytical" presentation of the BoP (BPM6, Chapter 14 and Appendices 1 and 9), a distinction is made between autonomous above-the-line items and below-the-line "exceptional" financing items. The analytical presentation of the BoP is instrumental for determining the BoP need in Fund operations. It distinguishes between above-the-line transactions that are deemed 'autonomous'—those "undertaken for the sake of the transaction"—and below-the-line items that are considered to be accommodating or financing the deficit. Below-the-line exceptional financing "brings together financial arrangements made by the authorities (or by other sectors fostered by the authorities) of an economy to meet balance of payments needs. These transactions can be viewed as an alternative to the use of reserve assets, IMF credit and loans to deal with payments imbalances or in conjunction with such use."

the NCB's TARGET balance (ΔTARGET) and flows of the general government (OTH(GOV))—for instance, those related to EU/IMF financial assistance programs.[11]

$$\mathbf{CA} = \mathbf{FA(private)} + \mathbf{FA(official)} + \mathbf{Residual} \quad (1)$$

- **Balance of payments financing needs in euro area member states manifest themselves in a net drain of funds out of the country from either the private or the public sector (reflected in financial transactions between residents and non-residents).** This is the case regardless of whether the drain is in foreign or domestic currency, or to countries inside or outside the currency union. In countries outside a currency union, a balance of payments crisis usually manifests itself when the country's current account deficit is no longer fully compensated by financial account (including official reserve) net inflows, with the currency typically losing value vis-à-vis other currencies. In the euro area, where part of the official foreign exchange reserves are pooled with the ECB and where the exchange rate is common, the external value of the euro will be influenced by the combined position of all euro area residents and could thus move independently of the BoP problems in one of the euro area countries.[12] If a net drain of funds in a euro area country is associated with a reduction in the availability of funding for banks in that country, these banks may, under certain conditions (e.g. availability of adequate collateral), obtain liquidity via Eurosystem refinancing operations or ELA.

- **BOP movements related to TARGET balances may have several sources, many of which are not related to a crisis-related net drain of funds.** Changes in TARGET balances must be mirrored in any of the other BoP components, in accordance with equation 2, below. This is true whether the liquidity used to fund the underlying cross-border payments is sourced from existing balances at the NCB, through interbank markets, or via monetary policy operations, and whether that liquidity is demand-driven (when banks obtain central bank liquidity in exchange for collateral) or supply-driven (when the Eurosystem provides central bank money in exchange for securities):**[13]**

$$\mathbf{\Delta TARGET} = \mathbf{CA} - \mathbf{FA(private)} - \mathbf{OTH(GOV)} - \mathbf{Residual} \quad (2)$$

- **Under certain circumstances ECB policy measures may have a de facto stabilizing impact on a euro area country's BoP.** For example, a detailed analysis of cross-border transactions in the period from mid-2011 to mid-2012 shows that the emergence of TARGET balances was partly related to the collapse in private financial inflows. The increase in TARGET balances was thus associated with a replacement of private sector funding of banks

[11] The other items (i.e. errors and omissions, the capital account and reserve asset flows) are included in the residual category in equation (1)).

[12] From the statistical reporting perspective (BPM6), "reserve assets must be foreign currency assets" (i.e. claims on non-residents of the currency union). By contrast, from a Fund law perspective, in a reserve-issuing currency union such as the euro area, holdings of euro reserves have both a "foreign" and "domestic" currency character to euro area members, as noted in the main paper.

[13] The residual also includes net flows in other investment of the NCB which are not changes in TARGET balances.

by central bank funding in a period of stressed bank funding conditions. During this period a substantial part of the liquidity provided by the Eurosystem to the euro area banking system was used by banks in stressed euro area countries for cross-border transactions, which led to an increase in TARGET liabilities and may have supported the BoP in these countries.

- **Large changes in TARGET balances may, however, also occur as a by-product of monetary policy implementation in the absence of any crisis-related external flows in the balance of payments.** The APP, which started in March 2015, has also coincided with rising TARGET balances. However, this period has not generally been characterized by crisis-related BoP developments in the formerly-stressed euro area countries. The increase in TARGET balances during this period is largely attributable to the interplay between the decentralized implementation of the APP and the financial structure of the euro area, as well as subsequent portfolio rebalancing. The net portfolio investment outflows observed during this period did not reflect crisis-induced external flows associated with sudden stops or capital flight, but rather constituted portfolio rebalancing towards foreign assets, as observed across the euro area, which is a standard reaction to QE operations. Hence, large changes in TARGET balances are not, per se, an appropriate indicator of crisis-related developments in the balance of payments of a euro area country.

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The above analysis provides useful detail regarding the legal, institutional, and policy frameworks that underpin the mandate of the EU institutions. From the staff's perspective, this material does not affect the policy proposals in the main staff paper (SM/17/237). In particular, as is the case with all Fund-supported programs, it is understood that any assurances provided by a central bank regarding its policy intentions are entirely voluntary and, moreover, must be consistent with the legal framework that underpins the mandate of the central bank in question. Indeed, safeguarding the independent decision-making of central banks has long been regarded by the Fund as a vital element in securing members' internal and external balance, and hence international monetary stability.

INTERNATIONAL MONETARY FUND

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PROGRAM DESIGN IN CURRENCY UNIONS— POLICY FRAMEWORKS OF THE WEST AFRICAN AND CENTRAL AFRICAN MONETARY UNIONS

Approved By
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Prepared by IMF staff.

Following the issuance of the Board paper on "Program Design in Currency Unions" (SM/17/237), staff has continued engagement with representatives of the two unions within the CFA Franc Zone. During this engagement, staff emphasized (i) that the proposed approach regarding policy assurances from union-level institutions would not infringe upon the independence of these institutions; and (ii) that, as discussed in the staff paper, special considerations apply when considering actions that would have a union-wide impact, as distinct from those that would only affect a single country. In the discussions, the representatives for these unions highlighted various aspects of the governance and monetary policy frameworks of these unions which they felt should be taken into account when policy assurances are sought. These frameworks are discussed below. They do not affect the staff's policy proposals in SM/17/237.

WEST AFRICAN ECONOMIC AND MONETARY UNION (WAEMU)

1. **Two treaties underlie the organization and functioning of the West African Franc Zone.** The West Africa Monetary Union (WAMU) treaty was signed in 1973 and was last revised in 2007. It established the monetary union of the member countries and stipulated the institutions in charge of the union's functioning. The West African Economic and Monetary Union (WAEMU) treaty complements the first treaty by extending the monetary union to an economic union. Specifically, it establishes a framework and set of institutions to, amongst other things, reinforce economic cooperation and convergence, harmonize laws and regulations, and ensure the mobility of goods and people. This treaty was originally introduced in 1994 and was last revised in 2003. A key institution of the economic union is the Commission of the WAEMU, which is led by commissioners who are appointed by the Conference of Heads of States and Governments. These commissioners are fully independent and operate for the common good of the union. They cannot solicitate or accept instructions from any

government or institution, and member states are obliged to respect their independence (WAEMU – Article 28).

2. **The Monetary Union is structured around a number of key bodies and institutions**. These include the Conference of Heads of States and Governments, the Council of Ministers, the Banking Commission, and the Central Bank of West African States (BCEAO) (WAMU – Articles 5 and 25). Among the specific institutions noted above, the two key strategic decision-making bodies are:

- The **Conference of the Heads of States and Governments**, which defines the broad policy direction of the union, approves the admission of new member states, and decides on any issues for which the Council of Minister has not been able to reach a consensus and which the Council has submitted to the Conference for decision.[1] The Conference also sets the overall directions of monetary, exchange rate, and financial sector policies, although the operational implementation of these policies is delegated to union-level institutions. The Conference meets at least once a year and decides by unanimous agreement.[2]

- The **Council of Ministers** ensures the implementation of policy directions and decisions by the Conference of Heads of States and Governments (WAMU – Article 16), and defines the regulatory environment for the banking and financial system and for the exchange rate (WAMU – Article 17). The head of the Council of Ministers is rotated across the membership.

BCEAO

3. **Governance.** The BCEAO, its organs, and personnel are prohibited from either soliciting or receiving directives or instructions from other union-level organs or institutions, from governments of WAMU member states, or from any other institution or individual. Union-level institutions and organs of the WAMU must also respect this principle (BCEAO Statutes – Article 4). The operational structure of the BCEAO includes the management team led by the governor, the Monetary Policy Committee, the Board of Directors, the Audit Committee, and the National Credit Councils.[3]

- The governor of the BCEAO is appointed by the Conference of Heads of States for a renewable six-year term. Vice-governors are appointed by the Council of Ministers for a renewable five-year term. The governor is responsible for the implementation of monetary policy.[4]

- The BCEAO's Monetary Policy Committee (MPC) is responsible for setting monetary policy (and establishing the associated implementation tools) for the WAMU (BCEAO Statutes

[1] Article 7 WAMU.

[2] Article 8 WAMU.

[3] Article 52 Statutes BCEAO.

[4] Article 62 Statutes BCEAO.

Articles 66). The MPC is composed of the BCEAO governor, vice governors, representatives of each member state, one member in charge of CFAF convertibility (representing France), and four other members nominated by the Council of Ministers.

- The BCEAO's Board of Directors is chaired by the governor or, when the governor is unavailable, by one of the vice-governors, and includes one representative appointed by the governments of each member state as well as France.[5]

- The Audit Committee assesses the quality of the administration, functioning, financial information, and control systems of the BCEAO.[6]

- The National Credit Council analyses the functioning of the financial system, including the banks' relationship with their clients, the management of the payment system, and the financing of economic activities. The Council may also be consulted on monetary and credit issues.[7]

4. Monetary and exchange rate policies are implemented in accordance with the following principles:

- **Monetary Policy**. The main objective of monetary policy is price stability, with sound and sustainable growth as a secondary objective (BCEAO Statutes – Article 8). From an operational viewpoint, the BCEAO (through the MPC) defines and implements monetary policy by setting the inflation objective and defining monetary policy tools. The MPC meets at least once a quarter and its decisions are taken by a simple majority of votes, with the vote of the president of the MPC breaking any ties. A quorum of two-thirds is needed for a valid decision to be made.

- **Exchange Rate Policy**. The Council of Ministers defines the exchange rate policy, in consultation with the governor of the BCEAO. The Council of Ministers appoints an Exchange Rate Committee to assist the Council. The BCEAO is in charge of implementing the exchange rate policy set by the Council of Ministers (BCEAO Statutes – Article 9). Within the union, reserves are pooled and capital flows freely (WAMU – Articles 2-3). When the average net external assets of the BCEAO are less than 20 percent of the average short-term liabilities for three consecutive months, the governor informs the president of the Council of Ministers and calls an extraordinary session of the Monetary Policy Committee to examine the situation and take appropriate measures (BCEAO Statutes – Article 76).

- **Foreign Exchange Management**. The management of foreign exchange reserves by the BCEAO is governed by an institutional framework which includes (i) the Cooperation

[5] Articles 80 and 81 Statutes BCEAO.

[6] Article 87 Statutes BCEAO.

[7] Article 93 Statutes BCEAO.

Agreement between the French Republic and WAMU member states (referred to below as the "Operations Account Agreement"); and (ii) the statutes and management rules of the BCEAO.[8] Under the operations account mechanism opened with the French Treasury, the BCEAO can resort without limit to advances from the French Treasury, although a minimum threshold for external assets—at least 20 percent of short-term liabilities—is set to prevent the account from being persistently overdrawn. The institutional framework also specifies that when the available deposits in the operations account will be insufficient to fulfill payments, the BCEAO will have to fund the operations account by drawing down its other liquid foreign exchange assets. The Operations Account Agreement was amended in 2005, resulting in major changes to:

- lower the portion of operations account deposits which the BCEAO must hold in foreign currency from 65 percent to 50 percent;
- ensure that only the portion of foreign currency held in the operations account is subject to the foreign exchange guarantee;
- ensure that the mandated portion of the BCEAO's foreign currency deposits held in the operations account is remunerated at the European Central Bank rate;
- diversify the investment tools for foreign currency assets not deposited with the operations account.

Banking Commission

5. The overall responsibility for the stability of the financial system is held by the regional Banking Commission, with the national authorities (specifically, the Ministry of Finance) playing a role in the supervision of microfinance institutions operating in their territory. The Banking Commission is responsible for ensuring the soundness of the banking system of the monetary union and, in particular, the supervision of credit institutions and the resolution of banking crises.[9] While the Banking Commission is distinct from the BCEAO, it is chaired by the governor the BCEAO. It consists of two decision making bodies (one for supervision and another for resolution) assisted by a secretariat.

CENTRAL AFRICAN ECONOMIC AND MONETARY COMMUNITY (CEMAC)

6. Two conventions and one treaty underlie the organization and functioning of the Central African Franc Zone. These are the Central African Monetary Union (UMAC) convention, the Central African Economic (UEAC) convention and the Central Africa Economic and Monetary Union

[8] The "Operations Accounts" are sight accounts opened at the French Treasury by the BEAC and the BCEAO. They hold a share of the pooled reserves for each union. Deposits in these accounts are compensated and the accounts offer the possibility of an unlimited overdraft.

[9] Article 2 Annex to Convention on the Banking Commission of UMOA as amended by Decision N0. 010 of 9/29/2017/CM/UMOA.

(CEMAC) treaty. The first was signed in 1972 and was last revised in 2008. It established the monetary union and stipulated the institutions responsible for the union's functioning. The UEAC convention and the CEMAC treaty were originally introduced in 1994 and were last revised in 2008. The UEAC convention complements the UMAC convention by extending the monetary union to an economic union (UEAC) by establishing a framework and a set of institutions to, amongst other things, reinforce economic cooperation and convergence, harmonize laws and regulations, and ensure the mobility of goods and people. The CEMAC treaty provided an umbrella framework for both conventions. A key institution of the CEMAC is the Commission of the CEMAC, which is led by commissioners who are appointed by the Conference of Heads of States (CEMAC – Article 27). These commissioners are fully independent and operate for the common good of the union. They cannot solicitate or accept instructions from any government, institution or individual. Members States have the obligation to respect the independence of these Commissioners (CEMAC – Article 31).

7. The Central African Monetary Union includes a number of decision-making bodies, including the Conference of Heads of States, the Ministerial Committee, and the Council of Ministers (UMAC – Article 9).

- The **Conference of Heads of States** determines the policies of the union and guides the actions of the Council of Ministers (UEAC) and the Ministerial Committee (UMAC). The Conference of Heads of States meets at least once a year and makes its decisions by consensus.

- The **Ministerial Committee** examines the broad policy directions of member countries and ensures their coherence with the common monetary policy. It oversees the enforcement of the UMAC treaty (UMAC – 11-12). The head of the Ministerial Committee is rotated across the membership.

- The **Council of Ministers** establishes the direction of the economic union as defined by the UEAC convention.

In addition to these decision-making bodies, the institutions of the union include the Bank of the Central African States (BEAC) and the Banking Commission.[10]

BEAC

8. Governance: The operational structure of the BEAC consists of the Board of Directors, the Monetary Policy Committee, the management team (the "*gouvernement de la BEAC*"), and the national Monetary and Financial Committees.[11]

[10] Article 10 CEMAC.

[11] Article 27 BEAC Statutes.

- The Board of Directors consists of fourteen members, two directors for each member state and France, appointed for renewable three-year terms. The Board of Directors is chaired by the governor of the BEAC.[12]

- The Monetary Policy Committee (MPC) sets monetary policy on behalf of the BEAC, and establishes the associated policy implementation tools (UMAC – Article 22; BEAC – Articles 1 and 38). The MPC is presided over by the governor of the central bank and includes 14 other members, two for each member (one of whom is the Director of the national BEAC branch), and two representing France. Monetary policy is implemented by the Management team of BEAC (BEAC – Article 47).

- The BEAC management team is led by the governor, assisted by a vice-governor, a secretary general and three directors general.[13] The governor is appointed by the Conference of Heads of State, following a nomination by the Ministerial Committee, and after confirmation by the Board of Directors. The governor is appointed for a non-renewable seven-year term. Other members of the management team are appointed for a non-renewable six-year term.

- Members of the management team must follow the principles of independence, impartiality and neutrality in undertaking their duties. Members of the Monetary Policy Committee (including the governor) cannot solicitate or receive directives or instructions from other union-level organs or institutions, from governments of member states of the CEMAC, or from any other institution or individual (BEAC – Article 41).

9. Monetary and exchange rate policies are implemented as follows:

- **Monetary Policy.** The main objective of monetary policy is to guarantee the stability of the currency, with a secondary objective of supporting economic policies adopted by member countries (UMAC – Article 21; BEAC – Article 1). The MPC meets at least once a quarter and its decisions are taken by a simple majority of votes, with the MPC's president breaking any ties (BEAC – Articles 42-43). National monetary and financial committees also are in place in each member country. These assess each country's demand for credit (*besoins généraux de financement de l'économie*), determine the domestic tools and means to meet these needs, and make proposals on the coordination of national policies with regional monetary policy.

- **Exchange Rate Policy and Reserves Management.** Within the union reserves are pooled, and capital flows freely (UMAC – Articles 3 and 5). The management of foreign exchange reserves is governed by an institutional framework which includes (i) the Cooperation Agreement between the French Republic and UMAC member states (referred to below as the "Operations Account Agreement"); and (ii) the statutes and management rules of the BEAC. A share of pooled reserves is deposited in the "Operations Account" and the rest is managed in line with the BEAC's investment guidelines and risk management framework. Under the operations account mechanism opened with

[12] Article 30 BEAC Statutes.

[13] Article 46 BEAC Statutes.

the French Treasury, the BEAC can resort without limit to the advances from the French Treasury, although a minimum threshold for external assets—at least 20 percent of short-term liabilities—is set to prevent the account from being persistently overdrawn. The institutional framework also specifies that when the available deposits in the operations account will be insufficient to fulfill payments, the BEAC will have to fund the operations account by drawing down its other liquid foreign exchange assets. An alert system is in place to avoid a persistent deficit in the "Operations Accounts":

- When a country has a deficit in the "Operations Account," the BEAC governor calls on the Ministerial Committee of the BEAC members and the concerned country to undertake adequate measures to correct the situation (BEAC – Article 11).

- When the ratio of the BEAC's average external assets to its average short-term liabilities (due in 12 months or less) is less than or equal to 20 percent for three consecutive months, the following measures are also triggered. First, refinancing ceilings are reduced by 20 percent for countries with a deficit in the "Operations Account," and by 10 percent for countries with a surplus in the "Operations Account" representing less than 15 percent of currency in circulation. Second, the monetary policy committee must immediately deliberate on remedial measures for countries with a deficit position in the "Operations Account."

Banking Commission

10. The Banking Commission is responsible for the supervision of credit institutions. The Commission has two central functions, to: (i) ensure that credit institutions adhere to the rules and regulations issued by national authorities, the BEAC, and by the Banking Commission; and (ii) impose sanctions for breaches of these rules and regulations. Among other responsibilities, the Banking Commission issues liquidity and solvency rules. While the Banking Commission is distinct from the BEAC, it is chaired by the governor the BEAC, assisted by the vice governor. The Banking Commission has no explicit responsibility in the resolution of crises.

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The above analysis provides useful detail regarding the legal, institutional, and policy frameworks that underpin the institutions of the CFA Franc Unions. From the staff's perspective, this material does not affect the policy proposals in the main staff paper (SM/17/237). In particular, as is the case with all Fund-supported programs, it is understood that any assurances provided by a central bank regarding its policy intentions are entirely voluntary and, moreover, must be consistent with the legal framework that underpins the mandate of the institution in question. Indeed, safeguarding the independent decision-making of central banks has long been regarded by the Fund as a vital element in securing members' internal and external balance, and hence international monetary stability.