Strengthening IMF program support and crisis resolution

CHAPTER • 5

Countries that belong to the IMF can request a loan when they are experiencing balance of payments problems—when they cannot borrow sufficient financing on affordable terms in financial markets to make international payments. The IMF's loans are available under a variety of policies and lending instruments tailored to the specific circumstances of different kinds of countries and problems. Most loans are conditional on borrowers implementing stabilization policies and reforms designed to address the country's balance of payments problems and other economic weaknesses and promote sustainable economic growth. In low-income countries, IMF-supported policy programs focus particularly on the objectives of growth and poverty reduction. The conditions attached to Fund loans are also intended to ensure that the Fund is repaid, so that its resources become available for other countries in need. (The Fund's instruments and associated programs are described in Table 5.1.)

Although any member country, rich or poor, with a balance of payments problem can apply for an IMF loan, since the late 1970s, when industrial countries began to be able to meet their financing needs in the international capital markets, all IMF lending has gone to emerging market, transition, or developing countries. In recent years, the greatest number of IMF loans have been made through the concessional Poverty Reduction and Growth Facility, but the largest loans are made through nonconcessional facilities and policies, including Stand-By Arrangements.

The IMF frequently reviews and refines its lending instruments to ensure that they meet members' needs, and studies the effectiveness of past programs. During FY2006, the IMF introduced two new instruments for low-income countries, the Policy Support Instrument and the Exogenous Shocks Facility; reviewed the design of programs under its Poverty Reduction and Growth Facility; undertook ex post assessments in countries with longer-term program engagement and ex post evaluations of exceptional access arrangements; and revised the operational guidance for its conditionality guidelines.

Ensuring that the Fund's financing instruments are adapted to the needs of member countries is a perennial challenge. Many emerging market countries have taken advantage of favorable economic and financial conditions to strengthen their net foreign asset positions, and growing access to capital has greatly reduced their need for Fund financing. During FY2006, both Argentina and Brazil repaid their entire outstanding obligations to the Fund ahead of schedule. Other members, particularly in Asia, have built up liquidity by accumulating international reserves and entering into regional agreements. For more details about developments in the IMF's financial operations and policies during FY2006, see Chapter 8.

In addition to providing loans to help countries recover from a crisis and resolve an external payments problem, the IMF works on issues relevant to the orderly resolution of financial crises, such as debt restructuring. Regarding its own role in this area, the Fund continues to monitor the implementation of its lending into arrears policy and will undertake a review of the policy in FY2007. In May 2005, the Executive Board discussed the factors that determine the pace at which countries emerging from a crisis are able to regain access to international capital markets.

Strengthening IMF program support

The IMF continued to aim for improved program design during FY2006. It issued revised operational guidance for the conditionality in Fund programs based on the lessons drawn from its 2004–05 Conditionality Review.[1] Evaluations of past IMF-supported programs, which began in 2003 as part of the Fund's response to the IEO's evaluation of prolonged use of Fund resources, continued to provide useful lessons for both program design and implementation.[2]

In FY2006, the Fund reviewed the design of programs supported by its Poverty Reduction and Growth Facility

[1]"Statement of the IMF Staff, Principles Underlying the Guidelines on Conditionality, Revised January 9, 2006," *www.imf.org/external/np/pp/eng/2006/010906.pdf;* and "Operational Guidance to IMF Staff on the 2002 Conditionality Guidelines, Revised January 9, 2006," *www.imf.org/external/np/pp/eng/2006/010906g.pdf.*

[2]See "Ex Post Evaluations of Exceptional Access Arrangements Guidance Note," *www.imf.org/external/np/pp/eng/2005/080805.htm;* and "Report on the Incidence of Longer-Term Program Engagement," *www.imf.org/external/np/pdr/ufr/2005/081605.htm.*

Table 5.1 IMF financial facilities

Credit facility	Purpose	Conditions	Phasing and monitoring[1]	Access limits[1]
Credit tranches and Extended Fund Facility[4]				
Stand-By Arrangements (1952)	Medium-term assistance for countries with balance of payments difficulties of a short-term character.	Adopt policies that provide confidence that the member's balance of payments difficulties will be resolved within a reasonable period.	Quarterly purchases (disbursements) contingent on observance of performance criteria and other conditions.	Annual: 100% of quota; cumulative: 300% of quota.
Extended Fund Facility (1974) (Extended Arrangements)	Longer-term assistance to support members' structural reforms to address balance of payments difficulties of a long-term character.	Adopt 3-year program, with structural agenda, with annual detailed statement of policies for the next 12 months.	Quarterly or semiannual purchases (disbursements) contingent on observance of performance criteria and other conditions.	Annual: 100% of quota; cumulative: 300% of quota.
Special facilities				
Supplemental Reserve Facility (1997)	Short-term assistance for balance of payments difficulties related to crises of market confidence.	Available only in context of Stand-By or Extended Arrangements with associated program and with strengthened policies to address loss of market confidence.	Facility available for one year; frontloaded access with two or more purchases (disbursements).	No access limits; access under the facility only when access under associated regular arrangement would otherwise exceed either annual or cumulative limit.
Compensatory Financing Facility (1963)	Medium-term assistance for temporary export shortfalls or cereal import excesses.	Available only when the shortfall/excess is largely beyond the control of the authorities and a member has an arrangement with upper credit tranche conditionality, or when its balance of payments position excluding the shortfall/excess is satisfactory.	Typically disbursed over a minimum of six months in accordance with the phasing provisions of the arrangement.	45% of quota each for export and cereal components. Combined limit of 55% of quota for both components.
Emergency Assistance	Assistance for balance of payments difficulties related to the following:		None, although post-conflict assistance can be segmented into two or more purchases.	Generally limited to 25% of quota, though larger amounts can be made available in exceptional cases.
(1) Natural disasters (1962)	Natural disasters	Reasonable efforts to overcome balance of payments difficulties.		
(2) Post-conflict (1995)	The aftermath of civil unrest, political turmoil, or international armed conflict	Focus on institutional and administrative capacity building to pave the way toward an upper credit tranche arrangement or PRGF.		
Facilities for low-income members				
Poverty Reduction and Growth Facility (1999)	Longer-term assistance for deep-seated balance of payments difficulties of structural nature; aims at sustained poverty-reducing growth.	Adopt 3-year PRGF arrangements. PRGF-supported programs are based on a Poverty Reduction Strategy Paper (PRSP) prepared by the country in a participatory process and integrating macroeconomic, structural, and poverty reduction policies.	Semiannual (or occasionally quarterly) disbursements contingent on observance of performance criteria and reviews.	140% of quota; 185% of quota in exceptional circumstances.
Exogenous Shocks Facility (2006)	Short-term assistance to address a temporary balance of payments need that is due to an exogenous shock.	Adopt a 1–2 year program involving macroeconomic adjustments allowing the member to adjust to the shock and structural reform considered important for adjustment to the shock, or for mitigating the impact of future shocks.	Semiannual or quarterly disbursements on observance of performance criteria and, in most cases, completion of a review.	Annual: 25% of quota; cumulative: 50% of quota except in exceptional circumstances.

[1]Except for PRGF, the IMF's lending is financed from the capital subscribed by member countries; each country is assigned a *quota* that represents its financial commitment. A member provides a portion of its quota in foreign currencies acceptable to the IMF—or SDRs (see Chapter 8)—and the remainder in its own currency. An IMF loan is disbursed or drawn by the borrower *purchasing* foreign currency assets from the IMF with its own currency. Repayment of the loan is achieved by the borrower *repurchasing* its currency from the IMF with foreign currency. See Box 8.1 on the IMF's Financing Mechanism. PRGF lending is financed by a separate PRGF Trust.

[2]The *rate of charge* on funds disbursed from the General Resources Account (GRA) is set at a margin over the weekly interest rate on SDRs. The rate of charge is applied to the daily balance of all outstanding GRA drawings during each IMF financial quarter. In addition, a one-time service charge of 0.5 percent is levied on each drawing of IMF resources in the GRA, other than reserve tranche drawings. An up-front commitment fee (25 basis points on committed amounts up to 100 percent of quota, 10 basis points thereafter) applies to the amount that may be drawn during each (annual) period under a Stand-By or Extended Arrangement; this fee is refunded on a proportionate basis as subsequent drawings are made under the arrangement.

[3]For purchases made after November 28, 2000, members are expected to make repurchases (repayments) in accordance with the schedule of expectation; the IMF may, upon request by a member, amend the schedule of repurchase expectations if the Executive Board agrees that the member's external position has not improved sufficiently for repurchases to be made.

	Repurchase (repayment) terms[3]		
Charges[2]	Obligation schedule *(Years)*	Expectation schedule *(Years)*	Installments
Rate of charge plus surcharge (100 basis points on amounts above 200% of quota; 200 basis points on amounts above 300% of quota).[5]	3¼–5	2¼–4	Quarterly
Rate of charge plus surcharge (100 basis points on amounts above 200% of quota; 200 basis points on amounts above 300% of quota).	4½–10	4½–7	Semiannual
Rate of charge plus surcharge (300 basis points, rising by 50 basis points a year after first disbursement and every 6 months thereafter to a maximum of 500 basis points).	2½–3	2–2½	Semiannual
Rate of charge.	3¼–5	2¼–4	Quarterly
Rate of charge; however, the rate of charge may be subsidized to 0.5 percent a year, subject to resource availability.	3¼–5	Not applicable	Quarterly
0.5%	5½–10	Not applicable	Semiannual
0.5%	5½–10	Not applicable	Semiannual

[4]*Credit tranches* refer to the size of purchases (disbursements) in terms of proportions of the member's quota in the IMF; for example, disbursements up to 25 percent of a member's quota are disbursements under the *first* credit tranche and require members to demonstrate reasonable efforts to overcome their balance of payments problems. Requests for disbursements above 25 percent are referred to as *upper* credit tranche drawings; they are made in installments as the borrower meets certain established performance targets. Such disbursements are normally associated with a Stand-By or Extended Arrangement. Access to IMF resources outside an arrangement is rare and expected to remain so.
[5]Surcharge introduced in November 2000.

(PRGF) and created a new window in that facility for helping low-income countries meet balance of payments needs arising from exogenous shocks. A group in the IMF's Fiscal Affairs Department set up to study the impact of Fund policies on poverty and social issues (Poverty and Social Impact Analysis, or PSIA), primarily in PRGF-eligible countries, became operational. This group's findings will be used to inform the design of future IMF-supported programs. For low-income countries that do not need or wish to borrow from the Fund but that want the Fund to monitor and evaluate their policies, the IMF introduced the Policy Support Instrument (PSI) in October 2005. The PSI will help countries design effective economic programs—as strong as those supported by Fund financial arrangements—and, once such a program has been approved by the IMF's Executive Board, will signal to donors, multilateral development banks, and markets the Fund's endorsement of a member's policies. The IMF's instruments for helping low-income countries are described in greater detail in Chapter 6.

The Executive Board held a preliminary discussion in June 2005 on the charges and maturities for IMF financing, with a focus on bolstering the revolving character of the Fund's resources.[3] Directors believed that the Fund's policies on charges and maturities could be made clearer, simpler, and more transparent, but they emphasized that any changes should be considered as part of a comprehensive reform package that provides appropriate incentives for repayment. Most Directors favored an alignment of surcharges across facilities in the General Resources Account, thereby removing the cost incentive for seeking exceptional access financing from one facility rather than another. Directors also called for the abolition of the policy on time-based repurchase expectations, viewing the existence of both expectation and obligation schedules as inherently confusing. However, such a move should be accompanied by the establishment of appropriate incentives to encourage advance repurchases, with many Directors taking the view that such incentives should be based on charges. Directors asked staff to further explore the options and to return with proposals.

In 2005, the Board reviewed the IMF's safeguards assessments policy. The main objective of the safeguards assessments policy, which was introduced in 2000 and made a permanent feature of Fund operations in 2002, is to minimize the possibility of countries misreporting information to the IMF and misusing Fund resources. Before member countries can use its resources, the IMF assesses their central banks' external and internal audit mechanisms, legal struc-

[3]The staff paper on which the discussion was based is available at *www.imf.org/external/np/pp/eng/2005/052305.htm*. The summary of the Board discussion can be found at *www.imf.org/external/np/sec/pn/2005/pn05101.htm*.

Box 5.1 Stand-By Arrangement for Iraq

The IMF's Executive Board approved a Stand-By Arrangement equivalent to SDR 475.4 million (about $685 million) for Iraq in December 2005 to support the country's 15-month economic program. Iraq, one of the IMF's founding member countries, received Emergency Post-Conflict Assistance from the Fund in September 2004.[1] That loan supported Iraq's economic program through 2005 and facilitated Iraq's negotiations with its Paris Club creditors over a debt-restructuring agreement. The Stand-By Arrangement, which will support Iraq's economic program for 2006, was a condition for the second stage of debt reduction agreed with Iraq's Paris Club creditors. The Iraqi authorities intend to treat the arrangement as precautionary.

Despite the extremely difficult security environment, the Iraqi authorities made progress toward macroeconomic stability in 2005. Growth was about 4 percent, following a rebound of almost 50 percent in 2004, although inflation remained high and volatile. The Central Bank of Iraq built up reserves and the exchange rate remained stable. The projected fiscal deficit was much lower than expected mainly because of higher-than-projected export prices for crude oil.

Iraq's program for 2006, which envisages an increase in economic growth, a reduction in inflation, and an increase in net international reserves, maintains a focus on macroeconomic stability, while improving governance and advancing Iraq's transition to a market economy. Throughout the rest of 2006, Iraq plans to expand the oil sector, cut back on general subsidies in favor of improving public services, and strengthen administrative capacity. The country's central bank is establishing a modern payments system and improving its supervisory capacity.

Iraq took an important first step in raising prices of refined petroleum products and now needs to press ahead to reduce fuel subsidies further and carry on with other structural reforms, including measures to enhance the efficiency and transparency of public financial management and the development of a comprehensive restructuring strategy for the state-owned banks. The central bank needs to develop the instruments required to strengthen its ability to conduct a monetary policy geared to ensuring price and financial stability.

[1]See *www.imf.org/external/np/sec/pr/2004/pr04206.htm.*

ture and independence, financial reporting framework, and internal controls.

The review included discussions on a staff paper, a report prepared by an independent panel of central bank officials,[4] and further work on a proposal to share reports on safeguards assessments with other international financial institutions. Following up on their April 2005 discussion, Directors concluded their review in December 2005. They considered the existing framework for assessing central banks' operations to be broadly appropriate and noted that the Fund's policy had had a positive impact on these operations, leading to improvements in governance and controls. They also agreed on a proposal to permit transmittal of safeguards assessments to other financial institutions, subject to assurances that similar reports from other international financial institutions would be shared with IMF staff and that the reports would be treated as confidential documents. Transmittal of reports will be subject to the consent of the central bank being assessed; initially, the reports will be shared only with the World Bank. The Fund's policies on charges and maturities, and safeguards assessments, are discussed in greater detail in Chapter 8.

Crisis resolution

The IMF continued its work on the orderly resolution of financial crises, analyzing cross-country experiences with sovereign debt restructuring and policy issues raised by specific cases, and promoting the use of collective action clauses (CACs) in international sovereign bonds. A review of the effectiveness of the Fund's instruments in facilitating crisis resolution is one of the priorities listed in the Medium-Term Strategy (see Chapter 2). The staff's "Progress Report on Crisis Resolution,"[5] which covers progress with initiatives such as CACs, the Institute of International Finance's *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets,* and the Paris Club's Evian Approach, as well as developments in sovereign debt restructuring cases, was discussed by the IMF's Executive Board on September 16, 2005.

Collective Action Clauses

CACs are designed to prevent small minorities of creditors from blocking restructuring deals to which large majorities agree. In its efforts to help improve the sovereign debt restructuring process, the IMF has encouraged the adoption of CACs, maintaining an active dialogue with private market participants and debt managers from a number of emerging market countries, including through such vehicles as the Forum for Public Debt Managers.

The adoption of CACs in international sovereign bonds has become the market standard for bonds issued under New York law. International sovereign bonds governed by English and Japanese law have continued the existing practice of including CAC provisions. As of end-February 2006, the share of emerging market sovereign bonds that include

[4]The staff paper, "Safeguards Assessments—Review of Experience," is available at *www.imf.org/external/np/pp/eng/2005/033105.pdf;* the "Report of the Independent Panel on Safeguards Assessments," at *www.imf.org/external/np/pp/eng/2005/013105.pdf.* The summary of the Board discussion can be found at *www.imf.org/external/np/sec/pn/2005/pn05170.htm.*

[5]See *www.imf.org/external/np/pp/eng/2005/092105.pdf.*

CACs climbed to 60 percent of the total outstanding stock of such bonds, in terms of their value, from 32 percent at the end of 2002. This reflects both the increased use of CACs in sovereign bond contracts and the recent sovereign debt exchanges that have replaced a large volume of bonds that did not include CACs with bonds that do include CACs. The inclusion of CACs has had no observable effect on the pricing of bonds.

Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets

Outside the Fund, the Institute of International Finance (IIF) reported that progress had been made on developing a monitoring process for its voluntary *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets,*[6] with the establishment of a Principles Consultative Group. The Group is seeking dialogue with debtor countries and creditors on transparency and investor relations. At the invitation of the IIF, IMF staff participated as observers in the Group's conference calls in November 2005 and February 2006, intended to allow private sector representatives and emerging market officials to participate in informal discussions with the Group about how the Principles apply to specific countries.

Sovereign debt rescheduling by the Paris Club

In October 2005, the Paris Club provided a flow rescheduling to the Dominican Republic under the Evian Approach—a flexible approach adopted by the Paris Club in 2003 for addressing the debt sustainability concerns of countries not receiving debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.

Following the Fund's approval in October 2005 of a Policy Support Instrument for Nigeria, Paris Club creditors granted Nigeria a comprehensive, concessional debt treatment. The treatment includes the clearance of arrears in two phases, together with a debt reduction under Naples terms on eligible debt, and the buyback of the remaining debt at a market-related discount. Consistent with the Evian Approach, the debt treatment was phased and aimed at providing a definitive solution to Nigeria's debt problems.

In December 2005, the Fund approved a Stand-By Arrangement for Iraq, which was a condition for the second stage of debt reduction agreed with Iraq's Paris Club creditors in 2004 (Box 5.1).

[6]For the current version of the Principles, see *www.iif.com/data/public/Principles.pdf.*

Dominican Republic

The Dominican Republic has staged a remarkable economic turnaround since its banking crisis in 2003–04. Large amounts of public assistance to bail out depositors and inadequate fiscal management had set off a vicious cycle of weak activity, high inflation, peso depreciation, growth of public debt, and capital flight.

Upon taking office in August 2004, a new administration formulated a comprehensive program aimed at strengthening macroeconomic policies and introducing a wide range of structural reforms. In January 2005, the IMF supported this program with a 28-month Stand-By Arrangement.

Macroeconomic performance in 2005 exceeded expectations, with real GDP growing 9.3 percent and inflation declining to 7.4 percent. The consolidated fiscal balance improved by 4 percentage points of GDP, owing to expenditure cuts and a tax package approved in late 2004. Net international reserves recovered, climbing to $850 million by the end of 2005.

With the restructuring of the Dominican Republic's external debt—a key element of the program—external bond spreads have dropped below 250 basis points. Two global bonds with combined principal of $1.1 billion were exchanged, with bondholders' participation at 97 percent. Commercial banks and Paris Club creditors restructured claims amounting to about $550 million, and a bond for $300 million was issued to buy debt back from a creditor, providing additional cash relief.

The country's Article IV consultation, completed in October 2005, focused on the significant challenges that lie ahead. Fiscal consolidation will require strengthening the revenue base, following the significant tax reform of late 2005; pursuing prudent expenditure policies; and improving fiscal institutions. Large financial losses in the electricity sector need to be reduced, and the central bank's financial position requires strengthening. The banking sector needs further strengthening, including enhanced supervision.

The Fund has provided technical assistance in the fiscal and banking areas, and the Dominican Republic has begun participating in the Fund's General Data Dissemination System (GDDS).

Dominican Republic–IMF activities in FY2006

October 2005	Executive Board completes first and second reviews of the Dominican Republic's Stand-By Arrangement
October 2005	Executive Board concludes the Dominican Republic's Article IV consultation
November 2005	The Dominican Republic formally begins participation in the GDDS

Nigeria

In October 2005, the IMF's Executive Board approved a two-year Policy Support Instrument (PSI) for Nigeria. Nigeria was the first of the IMF's member countries to benefit from the new instrument, which was approved in FY2006. The PSI is designed for low-income countries that may not need IMF financial assistance but that still seek close cooperation with the IMF in the preparation and endorsement of their economic policy frameworks. PSI-supported programs are based on Poverty Reduction Strategies developed by countries in a process in which civil society and development partners participate.

Nigeria's performance under the PSI has been strong. Real GDP growth in the non-oil sector accelerated to 8 percent in 2005, exceeding expectations. Inflationary pressures subsided in the fourth quarter of 2005 and in early 2006. Progress in implementing the structural reform agenda, as outlined in Nigeria's 2004 National Economic Empowerment and Development Strategy (NEEDS), has been excellent. The first review under the PSI was completed in April 2006.

The completion of the first PSI review enabled Nigeria and its Paris Club creditors to fully implement the agreement they reached in October 2005 on a comprehensive concessional debt treatment. Nigeria's external public debt will be reduced to a projected 4 percent of GDP by end–2006. Implementation of the debt agreement is well under way.

Nigeria-IMF activities in FY2006

July 2005	Conclusion of 2005 Article IV discussion
October 2005	Approval of a two-year Policy Support Instrument (PSI) for Nigeria
April 2006	Completion of the first review of Nigeria's PSI

Pace of market access by countries emerging from crises

The Executive Board held a seminar in May 2005 to discuss a paper by the IMF staff, "Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crises: Further Considerations," following up on an informal seminar on the same subject held in September 2001.[7]

Directors reaffirmed that the circumstances underpinning the loss of market access were a key determinant of how and when a country regained market access, noting that countries that lost market access because of adverse market developments normally regained access quickly if there was only a minor decline in investors' risk appetite that did not affect the assessment of the country's creditworthiness. When a country lost access because of both adverse market developments and policy slippages that caused concern about its ability to service its debt, it had to commit to policy adjustments to regain access, which could take anywhere from several months to approximately a year and a half when conditions in international capital markets were favorable. The length of time depended heavily on the strength of the country's corrective policies. Some Directors suggested caution in unduly relying on tightening monetary policy in response to crises, given the associated balance sheet effects. Structural reforms played a crucial role. Directors stressed the role that Fund policy advice could play in helping countries regain market access, and many Directors pointed to the importance of Fund financial assistance during the crisis.

A country that restructured its debt also had to demonstrate a commitment to strong corrective policies to regain access to markets. Countries that had bond restructurings had taken anywhere from 18 months to 5 or more years to regain market access, or 4 months to 4 years after completion of the debt restructuring, depending on the nature of the external environment and the success of their policy efforts. Directors also emphasized the importance of a sound and independent debt sustainability analysis in helping countries regain market access. It was also noted, however, that demand as well as supply factors influence capital flows, and that countries may choose to delay their reaccess to capital markets—for example, because of the cost of borrowing.

Directors stressed that countries seeking to regain access to international capital markets should put in place a strong communications strategy to explain to investors their efforts to strengthen their creditworthiness and the nature

[7]Available at *www.imf.org/external/np/pp/eng/2005/030105a.pdf.* The summary of the Board discussion can be found at *www.imf.org/external/np/sec/pn/2005/pn05132.htm.*

and objectives of their corrective policies. This would allow investors to better manage the information risk and to reassess the risk-return trade-off of possibly increasing their holdings of the country's debt. Directors believed that a country would benefit from open, two-way dialogue with investors.

For their first bond issue after regaining access to the markets, countries needed to give careful attention to selecting target investors and to the size and maturity of the bond. Market participants often preferred that such countries issue a fixed-coupon, bullet, or "plain vanilla" bond, which was easy to price and trade and facilitated price discovery. However, countries should also consider that issuing a bond with a more complicated structure could facilitate the management of certain risks.

Directors supported continued work by the staff in this area, including the development of a framework for predicting the pace and terms of market reaccess based on further analysis and country experiences, the potential role played by reaccess to domestic markets, and the effects of IMF support on market reaccess and the implications for the Fund's work.