INTERNATIONAL MONETARY FUND

The Fund's Mandate—Future Financing Role

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List of Abbreviations

ASEAN	Association of Southeast Asian Nations
AMF	Arab Monetary Fund
CMI	Chiang Mai Initiative
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EM	Emerging Market
ERM2	European Exchange-Rate Mechanism II
FAR	Andean Reserve Fund
FCL	Flexible Credit Line
FCT	First Credit Tranche
FLAR	Latin American Reserve Fund
GRA	General Resources Account
HAPA	High Access Precautionary Arrangement
IMFC	International Monetary and Financial Committee
IFI	International Financial Institution
LIC	Low Income Country
LOLR	Lender of Last Resort
MSL	Multicountry Swap Line
PCL	Precautionary Credit Line
PRGT	Poverty Reduction and Growth Trust
RAL	Reserve Augmentation Line or Rapid Access Line
RFA	Regional Financing Arrangement
RPA	Reserve Pooling Arrangement
RTP	Reserve Tranche Position
SBA	Stand-By Arrangement
SDA	Special Disbursement Account
SDR	Special Drawing Rights
VSTF	Very Short-Term Financing Facility

EXECUTIVE SUMMARY

Motivation and approach. Last year's major reforms of the Fund's lending instruments, together with the commitment to treble its resources, made a significant contribution to global stabilization as Fund lending created room for policy accommodation and helped countries weather the worst of the crisis. While these reforms have yielded positive results, it is appropriate to ask—as the IMFC has—whether there is scope to build on this experience. This paper tries to answer this question, including by drawing on the lessons of the crisis, as perceived by policymakers, market participants, and academic observers, with whom Fund staff has consulted extensively. While every effort has been made to explore the pros and cons of various reform options neutrally, some options are clearly more evolutionary (e.g., those building on last year's headline introduction of the Flexible Credit Line or FCL), while others are of a more radical nature (e.g., Fund provision of pure insurance payouts or collateralized lending). This paper focuses on the former, covering the latter set of ideas in a supplement. Once the Executive Board has had a chance to comment on all options, a more defined and specific set of proposals could be developed by staff for further consideration.

Issues with the global financial safety net. The crisis has highlighted three potential gaps in the global financial safety net.

- First, many members and observers feel that the FCL is not as predictable and effective an instrument as it might be. *The paper therefore discusses the case for modifications to the FCL's design, such as extending its duration and making qualification more predictable*.
- Second, there is a sense that the FCL caters to only a narrow a group of countries and that recent reforms offer too little to those well performing countries that do not make the FCL cut. *The paper therefore discusses the modification of the existing high access precautionary arrangement into a Precautionary Credit Line (PCL) targeted at these countries*.
- Third, it is unclear if the Fund has adequate instruments to act proactively to contain risks in a *systemic* crisis where several major players, with varying degrees of concern about Fund stigma, may benefit from an early and clear signal that they have access to financial resources to calm market fears stoking contagion. *The paper discusses how the Fund might, in well defined circumstances, make use of a Multicountry Swap Line (MSL) mechanism to offer liquidity lines unilaterally to a limited set of systemically-important countries with strong policy track records*.

Way forward. The importance of these gaps in the global architecture is debatable, but warrants early consideration—before another crisis strikes and before countries are led to accumulate excessive amounts of precautionary reserves, which is costly for themselves and the world as a whole. In doing so, care will need to be exercised in balancing the goal of a more effective global financial safety net against potential moral hazard and the need for adequate safeguards. This calls for better tailoring Fund lending to the varying strength of countries' fundamentals and policies. While further reforms of the Fund's financing role would help countries manage volatility better, the Fund is not the only institution with a mandate to provide a global financial safety net—central banks and regional financing arrangements clearly have a role to play here—and this too needs to be taken into account in striving to improve the current system.

"We ask the Fund, by the time of the next Annual Meetings, to study and report on the future financing role of the Fund. Building on the success of the FCL and high access precautionary arrangements, this study should consider whether there is a need for enhancing financing instruments and whether this can offer credible alternatives to self-insurance, while preserving adequate safeguards."

IMFC Communiqué, Istanbul, October 4, 2009

I. INTRODUCTION[1]

1. **The virulent contagion during the recent global crisis illustrated the importance of an effective global financial safety net to cushion shocks**. Cross-border integration has brought far-reaching benefits by broadening trade and financing opportunities. But globalization has also facilitated the spread of shocks across countries. The recent crisis is a case in point—originating in the main financial centers, it quickly engulfed other advanced economies before spreading to emerging market and low income countries (LICs). Some countries had home-grown vulnerabilities, while others were innocent bystanders hit by a series of global shocks: investor deleveraging, collapsing trade, falling commodity prices, and slowing remittances. Not surprisingly, the most integrated emerging market countries and the least diversified LIC economies suffered the most in this crisis.[2]

2. **When the crisis struck, it exposed gaps in the Fund's lending toolkit**. The Fund responded rapidly to assist members with immediate financing needs, but its ability to mount a preventative and systemic response was hampered by the inadequacy of its precautionary lending instruments and a resource base that had not kept up with the rapid increase in global trade and capital flows. In addition, stigma attached to Fund lending led some countries to seek other modes for meeting their financing needs, including swap lines from the U.S. Federal Reserve (the Fed) and precautionary loans from multilateral development banks. Even so, the Fund's traditional crisis resolution instrument, the Stand-by Arrangement (SBA), was used to good effect in this crisis.[3] And, with the potential for "old-style" balance of payment crises rooted in fiscal problems re-emerging as countries struggle with the after-effects of the crisis, the SBA is likely to remain the cornerstone of the Fund's lending toolkit.

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[1] Paper prepared by an interdepartmental team led by L. Giorgianni (SPR) and comprising C. Beaumont, L. Kohler, M. Rossi, and C. Visconti, (all FIN), W. Bergthaler, D. Eastman, K. Kwak, Y. Liu, C. Ogada, and R. Weeks-Brown (all LEG), M. Anthony, U. Das, C. Mulder, J. Pihlman (all MCM), S. Basu, A. Ghosh, J. Kim, J. Ostry, L. Ricci, and M. Roca (all RES), and G. Adler, M. Goretti, I. Halikias, J. Roaf, and A. Stuart (all SPR).

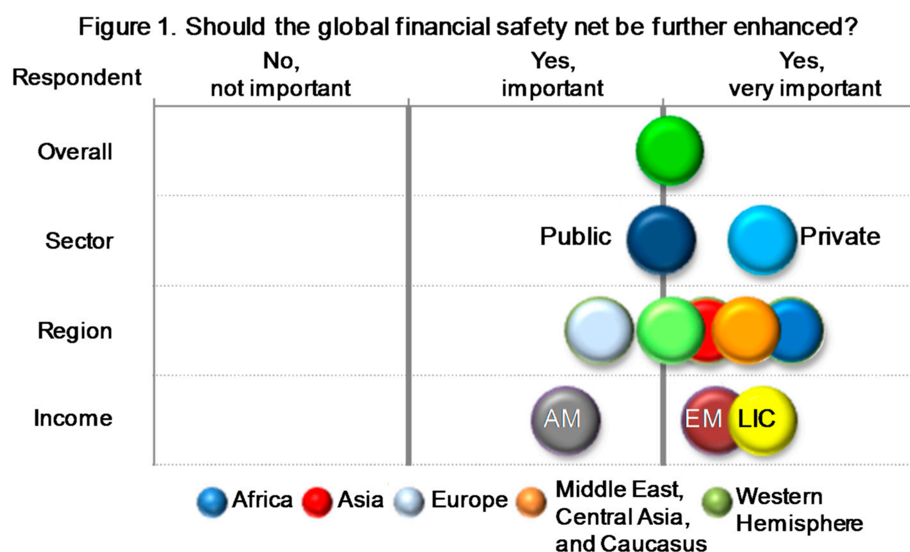
[2] See *How Have Emerging Market Countries Coped in the Crisis* (forthcoming) and *The Implications of the Global Financial Crisis for Low-Income Countries*.

[3] See *Review of Recent Crisis Programs*.

3. **The lending reforms introduced midway through the crisis have taken the Fund in the right direction**. Reforms introduced in early 2009 emphasized tailoring Fund conditionality to the varying strengths of members' policies and fundamentals—including by using of ex-ante conditionality; and making available effective crisis prevention instruments, which led to the creation of the FCL and the enhancement of high access precautionary arrangements (HAPAs).[4] These steps, backed by a commitment to treble the Fund's lending resources, helped stabilize financial markets and created space for countercyclical policies. Concessional facilities were also comprehensively overhauled, closing most gaps and increasing flexibility, to tailor them better to the needs of low-income countries.

4. **The crisis has offered valuable lessons that could be usefully internalized, building on recent reforms, to strengthen the global financial safety net**. In informal consultations with policymakers, market participants, and academic observers there was broad consensus on the lessons of the crisis and the implications for any future reform of the Fund's financing role (Figure 1). *First*, the magnitude and confluence of multiple shocks has heightened countries' perception of vulnerability and increased their desire for crisis insurance. *Second*, the virulence of the crisis, manifesting itself in dollar liquidity shortages and spreading quickly beyond countries with home-grown vulnerabilities, has illustrated the advantages of predictable *multicountry* mechanisms backed by adequate resources to provide liquidity in systemic crises. *Third*, the perception that countries with larger reserve buffers fared relatively better in the crisis may boost demand for reserve accumulation—a costly form of insurance. In addition, observers invariably pointed to stigma as a key factor inhibiting the effectiveness of the Fund's financing instruments.

Figure 1. Should the global financial safety net be further enhanced?



Source: Informal survey based on 101 respondents.

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[4] See *GRA Lending Toolkit and Conditionality—Reform Proposals*; *Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options* ; and *Conditionality in Fund-Supported Programs – Purposes, Modalities, and Options for Reform*.

5. **Without further reforms of the global financial safety net, countries may react to the crisis by accelerating costly "self-insurance" or even resorting to protectionism**.[5] A heightened perception of the risk of systemic shocks may induce countries to seek shelter by leaning excessively on exchange controls and restrictions, or on foreign reserve accumulation as a form of self-insurance. Sustained reserve accumulation, while carrying benefits in terms of financial independence and international status, is an inefficient form of insurance and may contribute to global imbalances.[6] Paradoxically, excessive reliance on self-insurance could collectively increase the risks that countries are individually seeking to mitigate by pursuing higher reserves. Reducing incentives for excessive self-insurance points to reserve-like (i.e., predictable and automatic) financing instruments, backed by adequate resources. But, going in this direction requires mechanisms to contain moral hazard and risks to the Fund, such as stronger links of lending terms or policy conditionality to the strength of borrowers' fundamentals and policies.

6. **As part of the work on modernizing the Fund's mandate, this paper reviews existing instruments and considers options for the future financing role of the Fund**.[7] Section II takes stock of countries' needs for insurance and financing, and compares alternative instruments to meet these needs with countries' strategies for self-insurance. Section III reviews the effectiveness of the Fund's financing role and offers a vision for reforms. Evolutionary ideas for further upgrading and expanding the Fund's nonconcessional financing instruments are presented in Section IV.[8] (More innovative reform options are considered in the Supplement paper). Section V concludes by considering how to integrate the various reform options most effectively and suggesting issues for discussion. The reforms considered in this paper may also carry implications for the size and modalities for mobilizing Fund resources—such topics will be covered in follow-up papers informed by this discussion.

II. Countries' Insurance and Financing Needs

7. **Countries can insure themselves against shocks, or mitigate their effects, in different ways**. Increasing countries' resilience to shocks ought to be the first line of defense—and emerging market and low income countries have been doing just that in recent

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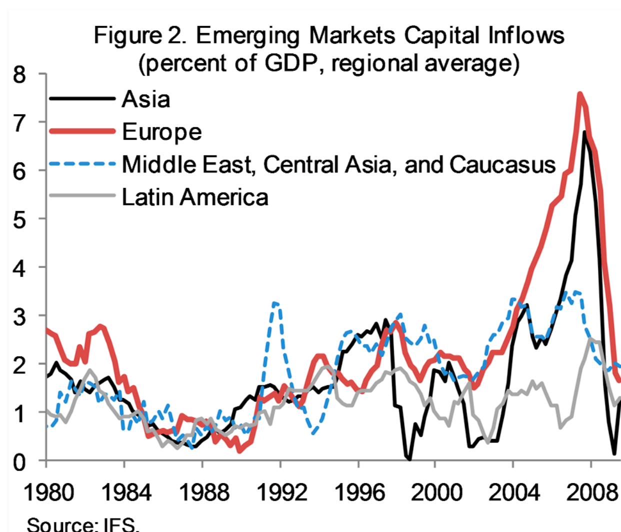
[5] See Becker et al. (2007), Ostry et al. (2010), Aizenman and Lee (2007), and Summers (2006).

[6] The upcoming paper on Reforms of the International Monetary System will discuss the source of global instability stemming from accumulation of reserves that is large relative to the size of the reserve issuers. See also Ghosh et al. (2009).

[7] See *The Fund's Mandate—An Overview*.

[8] Concessional facilities were overhauled recently. There may be scope for further refinements of the toolkit, in particular to address special challenges arising from catastrophic disasters and conflict situations. These issues will be taken up in separate papers. Further work on meeting low-income countries' growing demand for insurance may also be useful.

years, by improving policies and upgrading institutions.[9] The fallout from the global crisis would likely have been much worse were it not for these actions. Complementing these efforts, countries can also lower the risk profile of their economies by appropriately managing their financial assets and liabilities (Supplement paper, Box 2). Strengthened macro-prudential frameworks in countries where capital flows originate would also help avoid excessive risk-taking and volatility in asset prices (Figure 2). Beyond this, countries can manage shocks using the following types of instruments:



- ***Financing instruments**,* where the country secures access to credit either before the occurrence of an event (as a form of insurance) or to mitigate its effects after an event has occurred. Central bank swap lines and Fund arrangements are examples of financing instruments, as are credit lines provided by the private sector, although the latter have been used very infrequently (Analytical Basis for Fund Lending and Reform Options). The reform options considered in this paper focus on Fund-provided financing instruments.

- ***"Pure" insurance***, where the insured country pays a premium during normal times and receives a net pay-out (an unrequited transfer) conditional on the realization of a pre-specified event. An alternative form of pure insurance is making the present value of debt repayments contingent on the occurrence of a pre-specified event. Examples of pure insurance are very limited and concentrate on GDP-indexed and catastrophe bonds, or derivatives to hedge commodity price risk. The Fund's potential role to promote use of these instruments is discussed in the Supplement paper (Section III.C).

- ***Self-insurance***, where the country builds up foreign currency reserves to deter crisis contagion and to smooth the impact of adverse shocks. This tendency, and its associated costs, is discussed in an upcoming paper on the Reform of the International Monetary System.

8. **Although self-insurance is an inefficient instrument to deal with shocks, it has been pervasive in emerging market countries**. In theory, self-insurance is inefficient compared to pure insurance and financing because it does not exploit the benefits of pooling

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[9] See Ghosh, Ostry, and Tsangarides (2010).

risks.[10] Put simply, in order to provide US$100 of coverage against a tail risk, the country must lock up $100 all the time, regardless of how low the probability of the tail event is; it is far more efficient to pay a small fee—reflecting this low probability—to have access to $100 from an insurance pool when this coverage is needed. Relatedly, the carrying cost of reserves is typically estimated at a large multiple of the commitment fees charged for Fund precautionary instruments (Box 1). So, why do some countries accumulate large stockpiles of

Box 1. Costs and Benefits of Holding Foreign Reserves for Precautionary Motives[1]

Benefits of foreign reserves

Automaticity and fungibility. Foreign reserves can be used unconditionally for meeting any external financing need. They are usually invested in assets that are liquid and have little credit risk, thus limiting uncertainty as regards immediate availability and amount.

Crisis prevention. Foreign reserves can help prevent a balance of payment crisis through several channels, including the signaling associated with the ability to meet short-term obligations and stem a sharp depreciation of the currency.

Crisis resolution. Foreign reserves can be used to dampen the need for costly adjustments against temporary shocks, thereby mitigating the economic consequences of a crisis.

Costs of foreign reserves

The marginal cost of accumulating reserves is associated with the opportunity cost of foregone consumption and investment, which tends to be higher for lower income levels where the marginal utility of consumption is higher and needs for investment in physical infrastructure are larger. As this is a difficult concept to measure in practice, it is common to use as a proxy the fiscal, or accounting, cost defined as the spread between the interest paid on (local or foreign) debt issued by the insuring country and the return obtained in the relative safer and more liquid foreign reserve assets (see Edwards, 1985). For example, over the period 2000−07, the average EMBI spread was about 300 basis points and the difference between the 5-year treasuries and the 3-months Treasury bill was about 100 basis points, for a total fiscal cost of holding reserves of about 400 basis points.

Several authors have attempted to refine this concept:

- Rodrik (2006) argues that this measure based on the sovereign cost of borrowing underestimates the social cost of reserves and suggests instead of using the spread between the interest paid by the private sector on its debt and the return obtained by the monetary authority on foreign assets.
- Jeanne and Rancière (2006) argue that this measure overestimates the social cost of reserves, since part of the spread simply reflects compensation for default risk. However, to the extent default is politically costly, it may still be appropriate to account for some costs of default.

A broader measure of the cost of accumulating reserves should also include welfare costs associated with externalities at the national or the global level. The latter include possible contribution to global imbalances and excessive risk-taking, but also reduced contagion.

Importantly, the costs of holding reserves are typically not reported in government income statements. In fact, reserves are often regarded as an income-generating item, because they are treated gross of the corresponding domestic or external liabilities incurred in accumulating the reserves.

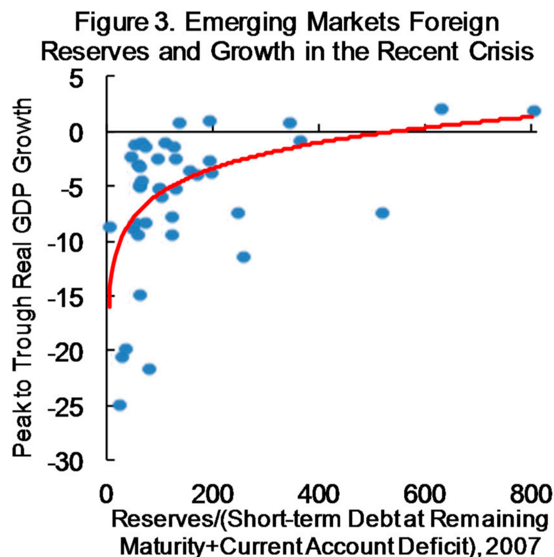
[1] See Ricci (2004) and Kim (2008).

[10] See Caballero and Panageas (2007).

reserves? Setting aside monetary and exchange rate policy considerations, which may be dominant in some cases, holding reserves carries a number of benefits compared with available insurance or financing instruments, such as a high degree of certainty of immediate availability (if invested in core reserve assets) and international status, including in the eyes of markets and rating agencies. Reserves may also be politically easier to justify to the electorate—especially if their carrying costs are not explicitly recognized in budgets—than pure insurance, where premiums are generally paid up front, or Fund financing, which may be seen as a sign of policy failure and may come with conditionality, or may not be made available in desired amounts.

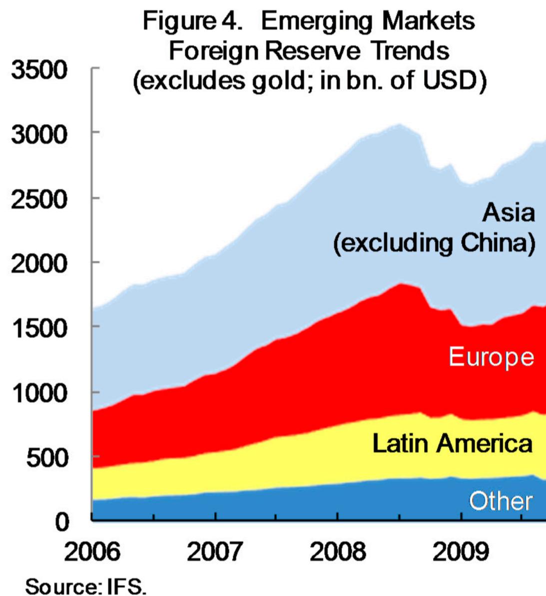
9. **The value of reserves, up to a point, is backed empirically**. In empirical studies, reserves tend to reduce spreads and exchange rate volatility (Levy Yeyati, 2008). In the recent crisis, reserve coverage of short-term debt has been associated with better growth performance among emerging market countries, although, importantly, the marginal benefits of self-insurance decrease rapidly as reserve coverage increases (Figure 3). This finding points to the benefit of complementing moderate holdings of own reserves by securing access to low-cost reserve-like instruments. In the meantime, some emerging market countries are stepping up reserve accumulation exiting from crisis, adding pressure for other countries to follow (Figure 4).

Figure 3. Emerging Markets Foreign Reserves and Growth in the Recent Crisis



Source: WEO and staff estimates.

Figure 4. Emerging Markets Foreign Reserve Trends (excludes gold; in bn. of USD)



Source: IFS.

III. The Fund's Financing Role

10. **The core mandate of the Fund is to provide temporary financing to shield countries from shocks and mitigate their costs**. The Fund's main modality for providing financial assistance to its members is by making available its resources in the General Resources Account (GRA). GRA lending is subject to policy conditionality and other requirements. By contrast, the Fund can provide reserve assets unconditionally by allocating

Special Drawing Rights (SDRs) uniformly to members in proportion to their quota. The Fund may also provide balance of payments assistance by using resources of the Special Disbursement Account (SDA), which are derived from the sales of pre-Second Amendment gold. Finally, it may provide assistance using resources contributed by members and other donors, which are administered by the Fund in separate trusts or accounts. The Poverty Reduction and Growth Trust (PRGT) is an example of a trust that has received both SDA and donor resources. The Fund's lending framework, which is explained in detail in Section II of the Supplement paper, has a number of appealing characteristics:

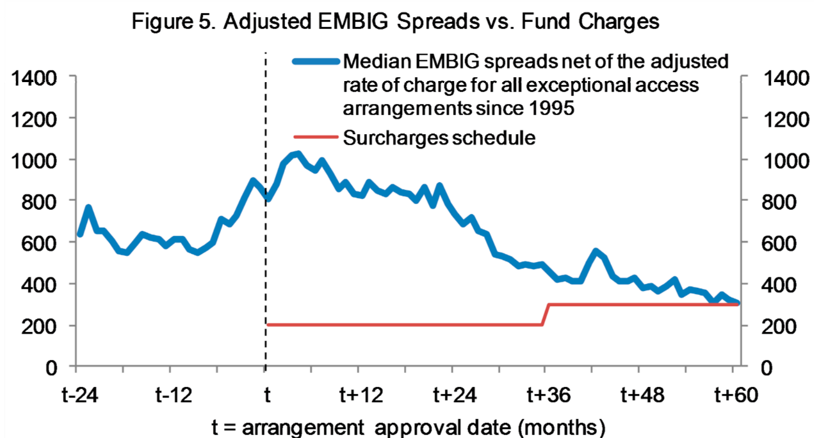
- ***Risk pooling***. The Fund can deal with both idiosyncratic and systemic shocks by pooling risks across its universal membership and by mobilizing large amounts of liquidity on a temporary basis.

- ***Countercyclical role***. When private financing dries up, the Fund can create global liquidity by allocating SDRs and extending financial assistance to allow policies to cushion the impact of shocks. Financial assistance and SDRs can be used flexibly to meet balance of payments needs arising from various sources, such as currency and bank runs or government refinancing pressures.

- ***Policy signaling***. Policy conditionality associated with Fund lending, either via ex ante qualification or ex post policy commitments, provides countries with an international seal of approval that helps catalyze private financing and facilitates creditor coordination (as in the recent European Bank Coordination Initiative to maintain bank exposures to emerging European countries). Conditionality also moderates the moral hazard intrinsic to any lender of last resort (these issues are covered in Section IV and Box 5).

- ***Price***. Relying on Fund resources is relatively inexpensive especially when compared to building own reserves. The Fund's cost advantage (Figure 5) reflects its cooperative nature, efficient risk pooling, its preferred creditor status, and the fact that costs are incurred only when Fund financing is secured. The Fund mobilizes resources through a financing mechanism based on the exchange of liquid reserve assets supported by a multi-layered framework protecting the Fund and its creditors

Figure 5. Adjusted EMBIG Spreads vs. Fund Charges

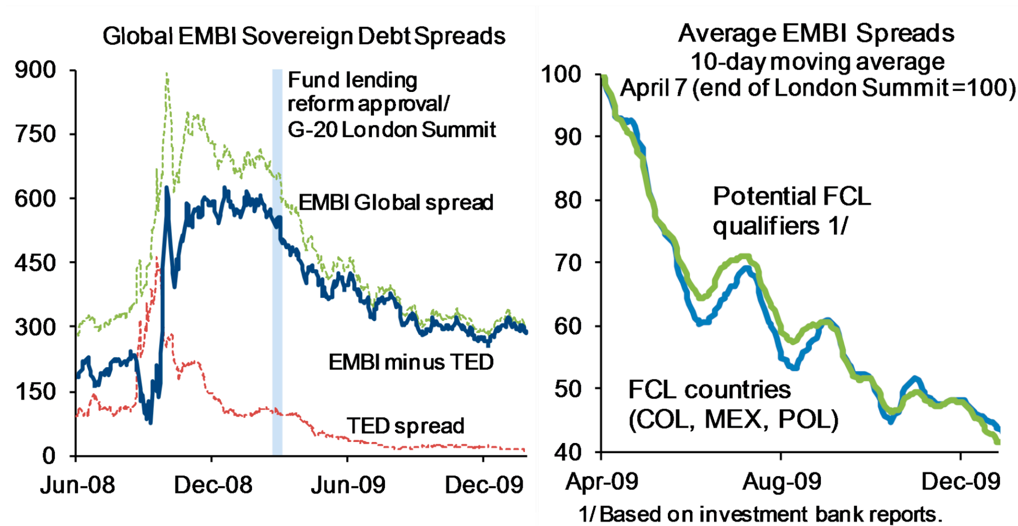


Sources: J.P. Morgan; Bloomberg; and Finance Department, IMF.

against financial risks: a first line of defense is provided by lending policies (conditionality, access, charges, and safeguards assessments); an additional risk-mitigating factor is the Fund's de facto preferred creditor status; residual credit risks are covered by precautionary balances.

11. **Midway through the crisis, the nonconcessional lending toolkit was overhauled and Fund resources sharply increased contributing to financial market stabilization.** The FCL was created to provide access to Fund resources with no ex post policy conditionality to countries meeting strict qualification requirements (ex ante conditionality). For countries not qualifying for the FCL, the SBA was enhanced to facilitate high-access lending on a precautionary basis (HAPAs). To reduce stigma, conditionality was made more focused (including by eliminating structural performance criteria) and greater emphasis was placed on holistic assessments of policy performance through review-based program monitoring. In addition, access limits were doubled. The implementation of these reforms at end-March 2009 was followed closely by the G-20 London Summit advocating a sizable increase in Fund resources. The combination of larger resources and more flexible lending instruments helped mitigate the risk of tail events, thus contributing to a generalized and sustained reduction in emerging market spreads, which had previously remained stubbornly high despite a rapid decline in measures of credit risk in advanced economies (the TED spread; see Figure 6).[11] Even countries that did not initially secure an FCL arrangement, but were seen by market participants as FCL eligible, benefitted from the lending reforms.

Figure 6. Emerging Market Spreads: 2008-10



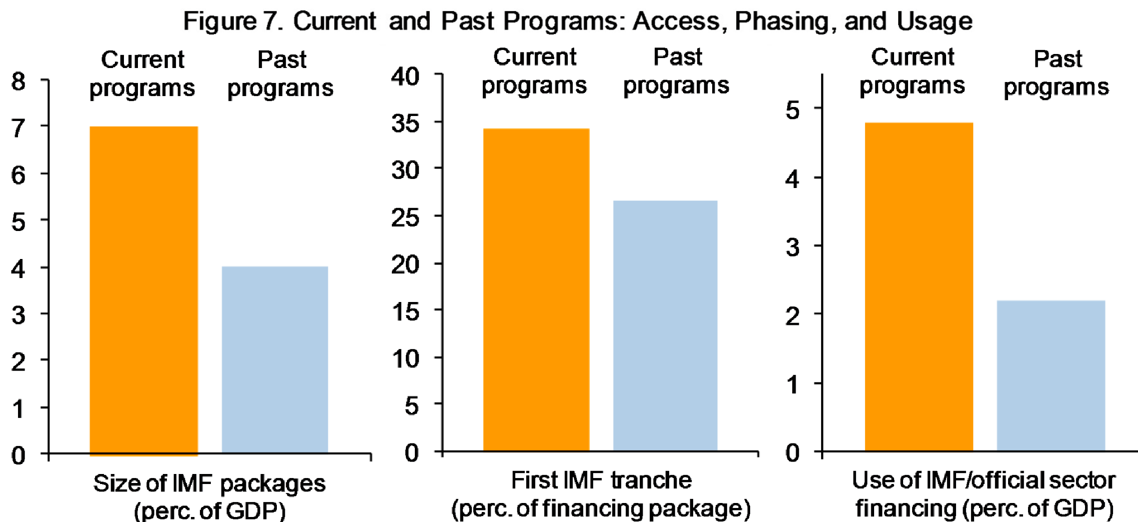
Source: Bloomberg.

12. **Countries that tapped Fund resources during the crisis were generally able to create space for countercyclical policies**. This is true for both countries that entered into

[11] In an event study, Izquierdo and Talvi (2009) argue that the strengthening of Fund facilities played a key role in stabilizing emerging market spreads.

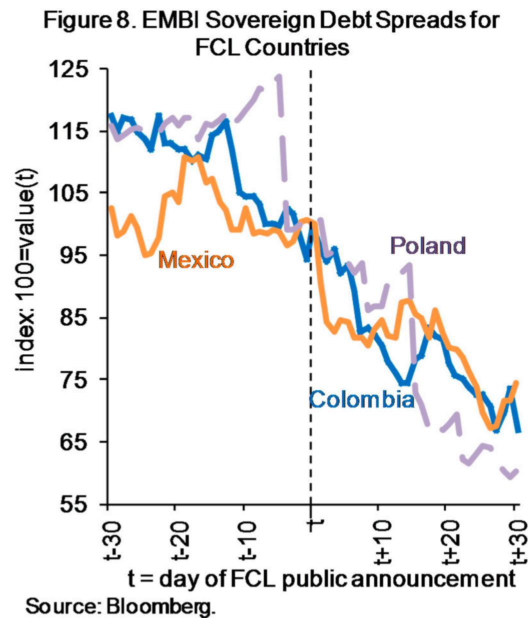
disbursing SBAs (19 countries since September 2008), where resources were provided speedily and in larger and more frontloaded amounts than in past crises (Figure 7), as well as for countries that availed themselves of precautionary resources under HAPAs (Costa Rica, El Salvador, and Guatemala) and FCL arrangements (Mexico, Colombia and Poland).[12]

Figure 7. Current and Past Programs: Access, Phasing, and Usage



Source: WEO; Finance Department ,IMF; and staff estimates.

Figure 8. EMBI Sovereign Debt Spreads for FCL Countries



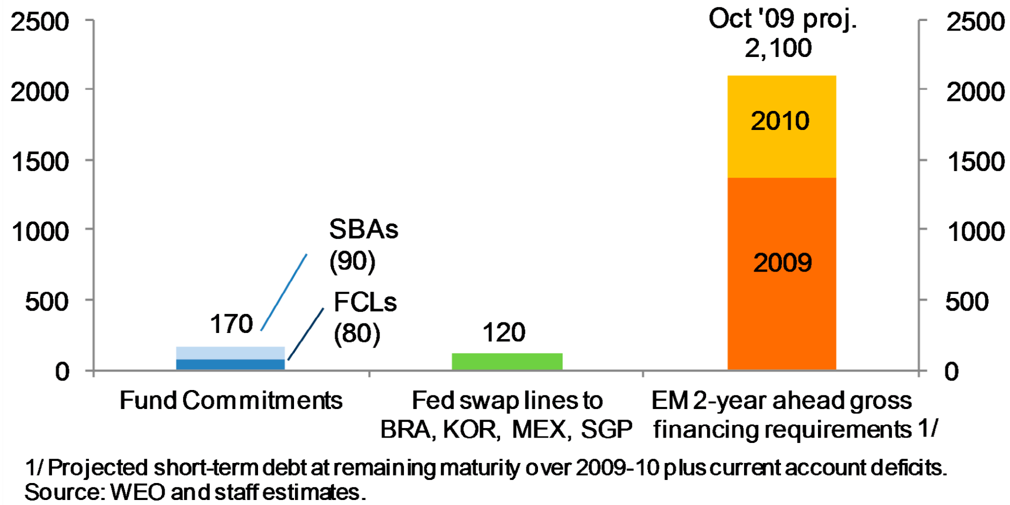
Source: Bloomberg.

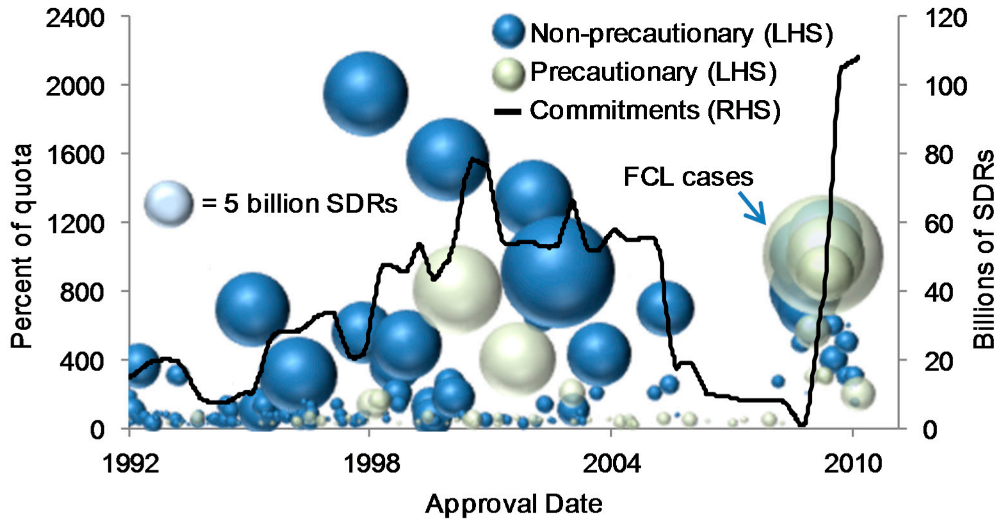
The generalized reduction in spreads following the establishment of the FCL, combined with the presence of only three FCL countries, render impossible a robust quantitative assessment of the impact of entering into FCL arrangements on country spreads (Figure 8). However, country authorities report that access to the FCL has helped them to secure continued *market* access—with significant bond placements at favorable yields—creating room for countercyclical policies. Colombia and Poland were among the few countries to escape a recession in 2009, the latter despite negative spillovers from the region. Mexico was also able to implement stimulative policies, setting the ground for an early recovery.

13. **Notwithstanding the benefits of reformed lending, countries have remained wary of turning to the Fund for nonconcessional assistance**. Despite having reached historic highs, the resources committed by the Fund in the recent crisis do not appear so large when

[12] The experience of countries that have entered into SBAs during the crisis has been reviewed in *Review of Recent Crisis Programs*.

compared to the financing needs of emerging market countries or the scale of central bank commitments (Figure 9). Moreover, demand for *precautionary* borrowing appears to have been lower than might have been warranted to stem contagion in a systemic crisis (Figure 10).There are a number of interrelated reasons for the observed tendency for countries to wait until turning to the Fund is unavoidable, and their preference to rely on own reserves:





- ***Lack of automaticity and predictability***. The Articles of Agreement ("Articles") require that GRA resources be conditioned on policy implementation and safeguards.

The perception that Fund financing decisions may be unduly influenced by creditor countries contributes to perceived lack of predictability.

- ***Stigma***. This often reflects negative connotations attached to the Fund itself (associated with experience in previous crises and exacerbated by factors such as perceived lack of legitimacy and unwillingness to entertain unorthodox policy solutions), as well as perceptions that conditionality, despite recent reforms and streamlining, remains heavy-handed and intrusive. Also, given that use of Fund resources has traditionally been associated with crisis resolution, countries may fear that turning to the Fund for crisis prevention would be interpreted by markets as signaling more severe problems than hitherto recognized.

- ***Alternatives to Fund financing***. Against this background, it is not surprising that major central bank's willingness to offer short-term swap lines to countries facing dollar liquidity shortages was met with great relief in several emerging market countries (Box 2). Rather than turning to the Fund, countries have also preferred financing with few strings attached from multilateral development banks (such as the World Bank's Deferred Draw-down Option and the Asian Development Bank's Countercyclical Support Facility).

14. **More broadly, a closer look at the nonconcessional lending toolkit reveals a number of possible shortcomings and gaps**. While the crisis has confirmed that the SBA, as the main crisis resolution instrument, offers adequate flexibility to deal with most individual country situations, the limited take-up of precautionary instruments (FCLs and HAPAs) raises questions about their design adequacy. Separately, the systemic nature of the recent crisis has prompted the question of whether a multicountry mechanism to stem virulent contagion may be useful. Stakeholders consulted informally by staff have generally underscored the following points (Box 3):

- ***Experience with the SBA***. The SBA has proven over many years to have adequate flexibility to resolve idiosyncratic crises and has been put to good use in the recent crisis for countries with significant vulnerabilities in need of support for policy adjustment and financing. The other traditional crisis resolution instrument, the Extended Fund Facility (EFF), has been used sparingly in recent years, although lately there has been renewed interest in it to deal with the low-access needs of LICs graduating from concessional assistance or with countries emerging from sovereign debt restructuring. While the EFF remains an appropriate instrument to deal with such situations and, more broadly, to support medium-term structural adjustment programs, the Board has recently stated a preference for not using it for high access.

Box 2. The Fed Swap Lines

In a move of seminal importance in controlling the crisis, the Fed established, on October 29, 2008, four swap lines for a uniform amount of up to US$30 billion each with the central banks of Brazil (equivalent to 650 percent of quota), Korea (670 percent of quota), Mexico (620 percent of quota), and Singapore (2,300 percent of quota). This step brought to 14 the number of Federal Reserve swap lines established during the crisis to address the global break-down in the U.S. dollar wholesale funding and swap markets.

Central banks could tap the swap lines up to approved amounts to counter dollar-funding constraints in their local markets. Such funding constraints were addressed through tender operations in U.S. dollars conducted by the counterpart central banks with their domestic financial institutions.

Outstanding drawings on the lines reached a total of almost US$600 billion at end 2008—mostly to the ECB (US$291 billion) and Bank of Japan (US$122 billion), followed by the Bank of England, Swiss National Bank, and Swedish Riksbank. The central banks of Korea and Mexico also drew on the swap lines but in smaller amounts.

Swaps entailed the exchange of domestic currency for dollars, had maturities ranging from overnight to three months, and carried a cost equivalent to the interest earned by the counterpart central banks on their tender operations, which were priced at a spread over Overnight Index Swap or LIBOR rates.

Importantly, the counterpart central banks absorbed all risks on the tender operations, which were mitigated through the use of collateral and haircuts on this collateral. Moreover, the Federal Reserve, which retained the right to approve or deny any request to draw on the swap lines, bore any residual credit risk arising from the counterparty central bank that was not covered by the foreign currency received in the swap. Such risk did not materialize, however, and all drawings were repaid in full. These lines were eventually closed on February 1, 2010.

- ***Experience with the FCL***. Low demand for the FCL during the recent crisis could partly reflect the relatively late creation of the instrument, or, as highlighted earlier, the fact that some countries were seen by market participants as meeting the FCL qualification requirements, or else availability of alternative financing sources. Beyond this, stakeholders have pointed out the following factors inhibiting FCL demand (Figure 11): (i) strong preference for own reserves; (ii) stigma generally attached to Fund lending; and (iii) uncertainty regarding FCL qualification. Finally, some policymakers have noted the burden associated with procedural requirements (for example, the need for a country to make an explicit written request—as opposed to accepting an offer from the Fund), which add to stigma.

Box 3. Fund Financing Role: Feedback from Academics and Market Participants[1]

Academics and market participants felt countries' inclination to self-insure with foreign reserves has become entrenched. The crisis is likely to have exacerbated further demand for reserve accumulation as countries with higher reserves were seen as having fared better. Moreover, it is difficult for any single country to stop or reverse reserve accumulation, unless all countries do so in unison. Drawing an analogy from banking, some felt that self-insurance was justified as is the need for banks to increase liquidity buffers. Overhauling Fund governance, making access to Fund resources more automatic and routine, and ensuring Fund resources are adequate were all seen as essential factors in reducing countries' demand for self-insurance. A number of interlocutors felt that much reserve accumulation was not primarily motivated by precautionary considerations.

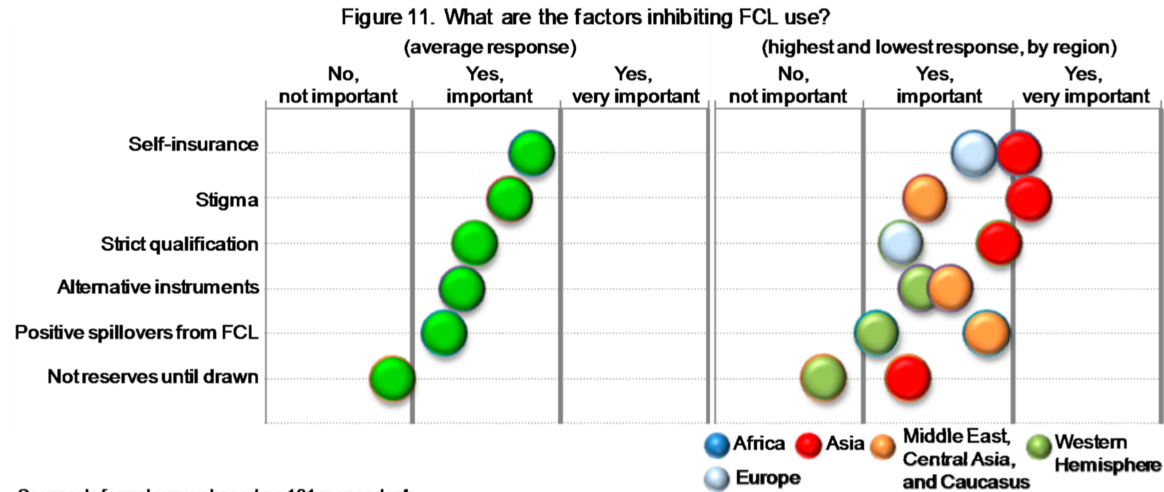
Nonetheless, the introduction of the FCL, without ex post conditionality, was seen as an extremely useful addition to the Fund's lending toolkit. The ability to use FCL resources flexibly, including for budget support, and its long repayment period were clear advantages over the short maturity (maximum 3 months) and narrow purpose (liquidity support to banks) of the Fed swap lines. However, some felt that the FCL's effectiveness suffered because it became available later in the crisis and followed the introduction of Fed's swap lines. The limited use of the FCL was also attributed to the stigma attached to Fund lending facilities—primarily a domestic public relations issue, given that market participants generally regarded use of the instrument positively. Thus, countries with temporary liquidity difficulties might have been dissuaded from using the FCL for fear of being perceived as facing graver liquidity problems, or worse, solvency issues. No such stigma was seen to be attached to accessing the Fed's swap lines as these were more technical instruments and one of many modalities for central banks to run their day-to-day operations.

There was consensus that lengthening the purchase rights under the FCL and increasing the flexibility of access decisions would enhance its effectiveness, as would treating it as a reserve asset. Some also thought that clarifying and making explicit its role for budgetary support would also help. Pre-announcing eligible countries was seen as one way of removing stigma, although some felt that there would be strong political objections to having such a list as it would impact negatively on those excluded countries. If FCL arrangements counted as foreign reserves, this would also improve their attractiveness.

There was broad support for a Fund lending instrument to deal with systemic crises. Such an instrument would have to be simultaneously opened to many countries and made state contingent, with triggers linked to the general situation of the world financial markets. As such, country qualification should be broad. With these characteristics, such an instrument would be effective in dealing with stigma concerns and could stand a chance of reducing incentive for self-insurance.

Views varied on the usefulness of innovative instruments, such as pure insurance or sovereign guarantees (covered in the Supplement paper). Some felt that even with Fund support markets would not be able to offer insurance against macro risks. Insurance contracts may also be unattractive to issuers as they involve payment of a premium upfront. There was more support for the Fund to make greater use of guarantees, similar to countries' actions to support the banking sector and other private sector activity during the crisis. Fund-provided guarantees might be less stigmatized than its lending facilities. With regard to reserve pooling and regional financial arrangements, some felt that only a truly global reserve pool would work (and that the Fund would be a natural place to manage it); others felt the Fund could efficiently leverage its resources to backstop such regional arrangements.

1/ Staff reached out informally to academics, market participants, rating agencies, think tank representatives, and policymakers through conference calls, country visits, and attendance of the seminar on "Mitigating Risks in the International Financial System" organized by the *Reinventing Bretton Woods Committee* and held in Incheon, Republic of Korea on February 26, 2010 (presentations available here).



- ***Experience with the HAPA***. Despite the recent reforms of the SBA framework to enable its more flexible use on a precautionary basis, demand for HAPAs has been limited—only three countries used this instrument during the crisis. A key issue appears to be stigma. More specifically, there may be a set of countries with good policies, yet not sufficiently strong to qualify for the FCL, for which the stigma of using an SBA may be too high to approach the Fund.

IV. Modernizing the Fund's Financing Role—Evolutionary Reforms

15. **This section considers a range of reform options for modernizing the Fund's financing mandate, illustrating their relative advantages and disadvantages**. Many of the ideas are not new—in fact, the broad range of issues at stake has long being debated by academics and policymakers (Box 4). Based on feedback from stakeholders, there is consensus on the need to strengthen the global financial safety net. Thus, the options presented below focus on evolutionary reforms that do not require changes to the Articles and for which Executive Directors signaled general support at the recent discussion of the Fund's mandate overview paper. Instruments considered here include bilateral credit lines and a multicountry mechanism for crisis prevention, as well as modalities for co-financing regional financing arrangements and reserve pools. Additional innovative ideas (such as lending against collateral, instruments for market support, contingent repayment schedules, and other pure country insurance instruments) are presented in Section III of the Supplement paper. These innovative ideas require amendments of the Articles or, within the current legal framework, the mobilization of non-GRA resources. Once the Executive Board has had a chance to comment on the range of reform options, a more defined and specific set of proposals could be developed by staff for further consideration.

16. **In considering new reforms of instruments, some caveats are worth noting**.

- ***Differentiating by country performance or type of balance of payments problem?*** The lending reforms implemented in early 2009 emphasized the benefits of a streamlined GRA toolkit giving emphasis to the flexible, all-purpose "credit tranche"

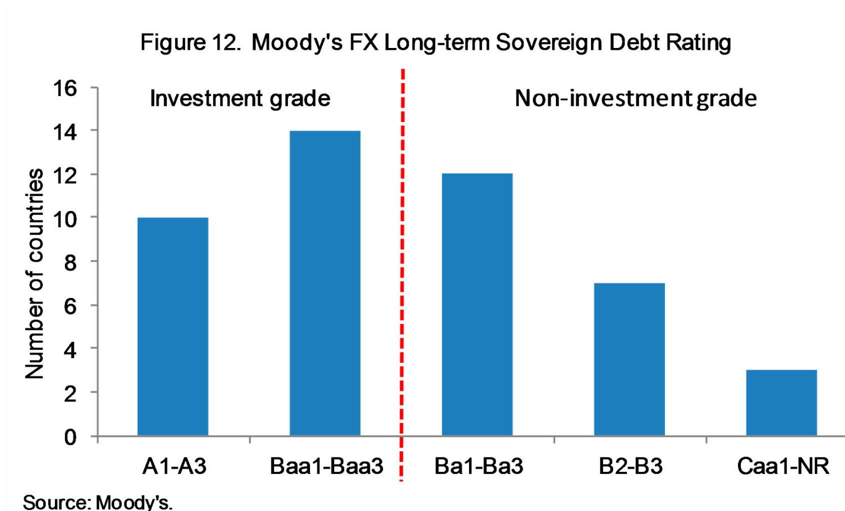
Box 4. Past Debates on the Fund's Financing Role

The Fund's financing role has been debated since its inception. One of its founding fathers, Keynes, believed the Fund should act as a "central bank for members" with large resources and automatic liquidity injections to debtor countries. The other, White, argued for a smaller Fund with lending extended on a discretionary basis and subject to policy conditions. This debate has continued and a number of alternative proposals on how to reshape Fund lending have been put forth over time. The principles set out by Bagehot—*in a crisis, a lender of last resort (LOLR) should lend freely, against good collateral, at a penalty rate of interest*—help illustrate the range of views over the key features of Fund financing.

- ***Scale/lending freely***. Views differ on the appropriate scale to stem limit contagion, given finite resources and moral hazard risks.[1] Mussa (2006), Eichengreen (2004), Truman (2006), and Cline (2006) support Fischer's (1999) proposal for the Fund as a limited LOLR that could lend to the specifics of the crisis, without strict access limits. The Meltzer Commission (2000) instead argued for strict qualification requirements for LOLR assistance to reinforce crisis prevention.
- ***Certainty/Automaticity***. Ubide (2005) argued that the Fund should address uncertainty about the availability of resources to help borrowers choose between the Fund and self insurance. He proposed a liquidity window at pre–determined interest rates that would limit rollover costs in the event of a liquidity run, similar to the proposal of Cordella & Levy-Yeyati (2005). Geithner (2004) suggested linking surveillance of medium-term policy frameworks with access to supplemental contingent resources to deal with short-term liquidity problems. Ostry and Zettelmeyer (2005) also support prequalification for contingent financing.
- ***Rules or constructive ambiguity***. Bagehot advocated stating the principles on which LOLR decisions would be taken to prevent bank runs, but constructive ambiguity has been more prevalent to stem moral hazard concerns. In the case of the Fund, the Meltzer Commission argued for qualification and clearer rules. But Mussa (2006), Truman (2006), Eichengreen (2004), and Cline (2006) have favored discretion as tailored responses to different circumstances are needed.
- ***Penalty rate***. Charging a penalty is a way to deal with borrower moral hazard. Mussa (2006) makes the case that the Fund's rate structure is appropriate given its preferred creditor status and historical repayment record. In addition, conditionality imposes an important nonfinancial cost on the member.
- ***Stigma***. Past Fund work has noted the similarity of stigma attached to the Fund with that attached to central banks. For example, the reluctance of banks to use the Fed discount window in the recent crisis led to a coordinated approach to de-stigmatize its use. The Bank of England established the Special Liquidity scheme to tackle stigma by prohibiting the publication of information about who has used it and in what amounts.
- ***Lending against collateral***. Commentators argue there is a tradeoff between ex-post policy conditionality and collateral, with the former providing a policy commitment tool and thus lending confidence. While the Fund has the right to require collateral it has rarely done so because it has judged its policy conditionality, including by playing a catalytic role for other financing, to be the most effective safeguard that a member will resolve its balance of payments difficulties and thereby be in a position to repay the Fund.

1/ King (1999) argues that unlike an IFI, a domestic LOLR can ensure that managers and equity holders of an institution do not benefit from a bailout. However, the Fund cannot lend into unsustainable situations—in such cases, a program is approved only when there is a combination of financing, policy adjustment and debt restructuring that would restore debt sustainability within the medium-term. Nor is it clear that domestic LOLRs have always avoided benefits to managers and shareholders in this crisis.

lending vehicle (which comprises the SBA and FCL windows), compared to special facilities intended to address special types of balance of payments problems (such as the Short Term Liquidity Facility, Supplemental Reserve Facility or the Compensatory Financing Facility, which were eliminated). While this general approach is still favored by staff, country heterogeneity (Figure 12) points to the need to adequately differentiate instruments along the spectrum of countries' policy characteristics—an approach exemplified in the design of the FCL.



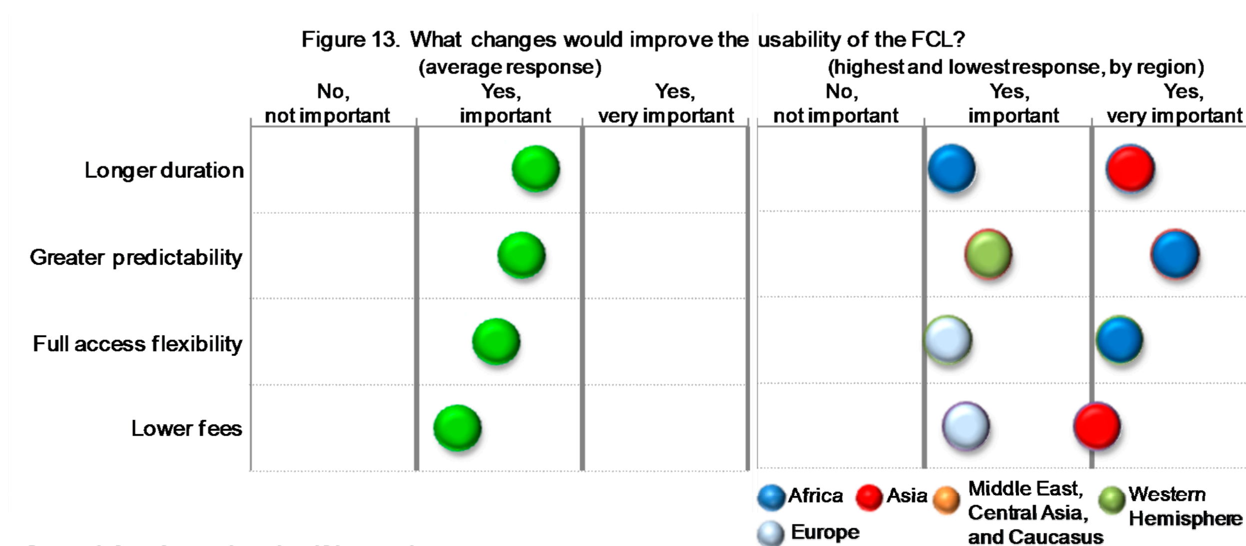
- ***Balancing access automaticity with moral hazard risks***. The advantage of greater automaticity needs to be weighed against the requirement that Fund finances be safeguarded and moral hazard attenuated. This suggests increasing automaticity only when dealing with countries with strong fundamentals and policies (Box 5).

- ***How to prioritize reform options?*** There are both synergies and redundancies among the ideas considered below, which will need to be weighed carefully in putting together a balanced package of reforms (see Section V).

Enhancing the Effectiveness of the Flexible Credit Line

17. ***Rationale***. Discussions with stakeholders suggest that the effectiveness of the FCL could be enhanced by increasing its substitutability with countries' own reserves. This means increasing the predictability of qualification and the duration of purchase rights, as well as removing the access cap—in order of importance based on the responses to an informal survey (Figure 13). A few stakeholders have also noted the need to reduce fees.

18. ***Lengthening duration***. As noted in the context of last year's GRA reforms, longer duration of automatic access could improve the substitutability of the FCL to reserves, but at the cost of weakening safeguards—a longer drawing window could limit the scope to identify a weakening of key macro policies that may necessitate corrective actions. Still, in practice, weakening of policies takes time in most cases—for example, country credit ratings



Box 5. Balancing Automaticity of Lending with Moral Hazard Risks[1]

Moral hazard in the sovereign context is frequently defined as any increased risk taking by debtors or creditors in response to the prospect of official financial support. Whether this implicit insurance leads to such behavior, however, depends on the type of shock and whether there are instruments to mitigate the moral hazard.

Since the likelihood of an ***exogenous*** shock cannot be influenced by the behavior of the individual country or its creditors, providing insurance against such shocks is unlikely to lead to moral hazard, while welfare gains associated with reducing tail risks are likely to be significant. A ***systemic liquidity shock***—affecting "innocent bystanders," as seen during the crisis—is a relevant example.

Idiosyncratic shocks, however, are likely to entail some degree of endogeneity to the behavior of the individual country or its creditors. In this case, full predictability and automaticity of access to lender of last resort financing could exacerbate moral hazard risks. But there are ways to mitigate these risks. The Fund has a number of instruments at its disposal:

- Moral hazard risks on the side of debtor countries can be mitigated by tailoring automaticity of access to countries' fundamentals and policies—so that only very strong performers have automatic access to Fund resources. In contrast, financing for members with weaker track records would need to retain some degree of ex-post conditionality, tailored to the country characteristics as the main mechanism for mitigating moral hazard.

- Moral hazard on the side of private investors, on the other hand, can be addressed by retaining, as part of the qualification criteria, an assessment of banking sector soundness and financial sector supervision. In addition, some degree of 'constructive ambiguity' is always retained at the level of the member's government or central bank (i.e. Fund resources would be committed unconditionally to the member, but their use would remain a prerogative of the latter).

[1] For a broader discussion of moral hazard in Fund lending see *Fund Financial Support and Moral Hazard: Analytics and Empirics*.

remain relatively constant over time (Figure 14)—and the very strong creditworthiness, market access, and track record of members qualifying for the FCL provide assurances that policies will continue to be aimed at ensuring sustainability and capacity to repay. Taking all this into account, as well as the Fund's de facto preferred creditor status, a good balance in the case of the FCL could be struck by lengthening the duration of purchase rights from 6 to 12 months. The current 6-month review for annual arrangements would be eliminated and multi-year arrangements with annual reviews could be allowed. In any case, it would be important to incorporate design features to facilitate smooth exit from the FCL.

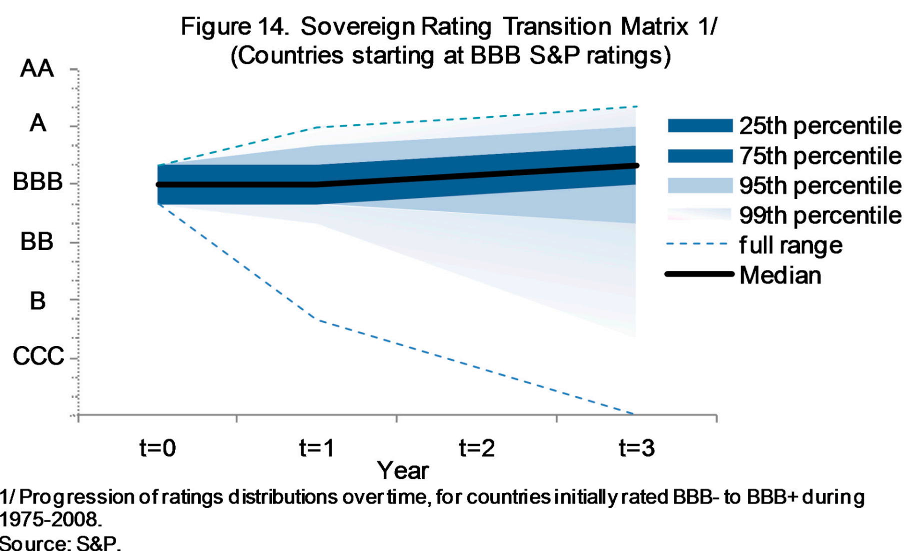


Figure 14. Sovereign Rating Transition Matrix 1/
(Countries starting at BBB S&P ratings)

1/ Progression of ratings distributions over time, for countries initially rated BBB- to BBB+ during 1975-2008.
Source: S&P.

19. ***Increasing predictability***. Lack of predictability of qualification may deter countries from approaching the Fund for fear of being turned down. Within the current judgment-based qualification process, greater predictability can be achieved by either (i) streamlining the qualification criteria to facilitate countries' self-assessment, for example, by reducing the number of criteria and making greater reliance on quantitative ranges to define what constitutes sustainable external positions, sound public finances, or low and stable inflation; or (ii) through pre-qualification, whereby countries are assessed and pre-approved before they request an arrangement. Pre-qualification could be achieved in two main ways:

- ***Surveillance***. One possibility would be to routinely conduct FCL qualification assessments in the context of Article IV consultations and introduce standardized language only in staff reports of countries that are expected to qualify for an FCL arrangement. Countries that do not meet the FCL's high qualification bar would not be singled out in staff reports. A variant to this approach would be to insert assessments of qualification in *all* Article IV reports, also indicating how (both favorable and unfavorable) policy changes would impact these judgments.[13]

[13] See Ostry and Zettelmeyer (2005) for a proposal along these lines.

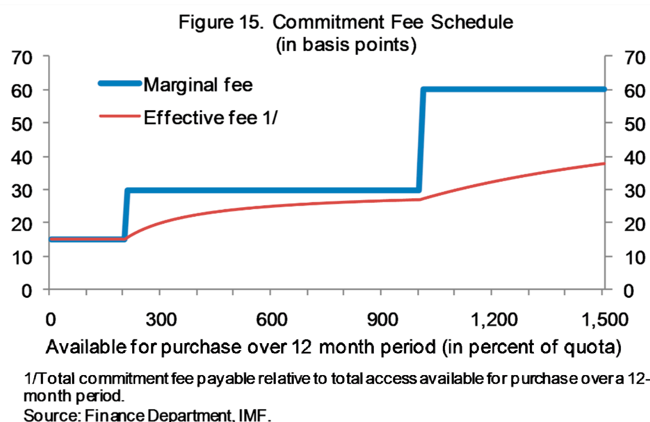
- ***Rule-based approach***. Alternatively, the qualification process could be automated via a set of transparent "Maastricht-like" criteria. This approach has the advantage of easing the risk of not disqualifying countries purely for fear of market reactions, but presents a number of practical challenges—including the choice of relevant quantitative criteria and the difficulty of using them to make forward looking assessments about the robustness of fiscal, monetary, and financial sector policies.

These approaches would impact not only the FCL's design, but would more broadly strengthen the links between surveillance and lending. Full predictability could provide incentives to members to strengthen their policies in order to comply, and thus enhance the traction of Fund surveillance. Assessments in Article IV reports would also destigmatize the application of "ratings" if made routinely and across the entire membership. These advantages need to be weighed against the potential market consequences and political sensitivities from labeling members, and the cost of reduced flexibility—which is at a premium in crisis situations.

20. ***Removing implied access cap***. Access under recent FCL arrangements has been close to the implicit 1000 percent-of-quota cap (see GRA Lending Toolkit and Conditionality: Reform Proposals, Section III.B.13; and PIN No.09/41 (4/3/09)). As foreshadowed in staff analysis that led to the creation of the FCL (see Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options), establishing an informal cap risked creating an access *target* as deviating from it could send adverse signals. The cap has, moreover, the counter-intuitive result of making the FCL less flexible than the SBA, which has no implicit or explicit hard caps on access, and can exceed (and in recent cases, has often exceeded) 1000 percent of quota. Taking into account these factors and the heightened safeguards provided by the very strong fundamentals and policies of FCL-qualifying members, eliminating this implicit cap could be contemplated. Separately, to avoid convoluted access justifications, new guidelines on access could be adopted to give substantial deference to the authorities' representations of potential need, as long as the representations are assessed by staff to be reasonable in the circumstances. As in any GRA lending, actual drawings under the FCL cannot exceed the member's balance of payments need at the time of the drawing.

21. ***Reducing costs***. As part of a package of measures to encourage members with strong policies and institutions to come to the Fund at an early stage, rather than wait until there is a crisis, moderately lower commitment fees under the FCL could be considered (Figure 15). While the opportunity and liquidity costs from committing resources remain the main costs in the case of large arrangements, such a reduction in fees would recognize the experience with the FCL to date that the costs in terms of staff and Board time are less

Figure 15. Commitment Fee Schedule
(in basis points)



1/Total commitment fee payable relative to total access available for purchase over a 12-month period.
Source: Finance Department, IMF.

than for a standard precautionary SBA. To provide an incentive to contain superfluous access requests, the existing upward-sloping schedule for the commitment fee should be preserved

22. ***Legal implications***. [14] The changes presented above could be implemented by amending the FCL decision with a majority of the votes cast except for the lowering of the commitment fees. The commitment fee is a form of charge under the Articles and, as such, is required to be "uniform for all members" (Article V, Section 8(d)). Differentiation of charges has been limited to relevant differences in members' use of the Fund's resources (e.g., having a different balance of payments need as addressed by a special facility), rather than on differences in member-specific characteristics (e.g., sovereign ratings). Establishing a special facility requires a qualified majority of the total voting power.[15] Moreover, given the purpose of commitment fees (to defray the cost of making an arrangement available even if it is not drawn) it would be necessary to demonstrate that the costs incurred in the administration of an FCL arrangement are lower that than those applicable to other arrangements.

Broadening access to FCL-style Credit Lines

23. ***Rationale***. Many have argued for ensuring members with good policies that do not qualify for the FCL have access to adequate FCL-like credit lines. To achieve this goal, two alternative approaches that seek to balance automaticity of access with the need to avoid moral hazard and safeguard Fund resources, could be contemplated: (i) broadening qualification for the FCL while differentiating access, duration, or charges according to the strength of members' policies and fundamentals; or (ii) adapting the current framework for high-access precautionary arrangements by creating a new window in the credit tranches, say, a Precautionary Credit Line, with upfront access. Here safeguards would be provided by capping access and subjecting access to qualification and light ex post conditionality. In both cases, stigma is likely to be shifted to the SBA, although this may not be problematic in so far as the instrument continues to be used for the resolution, and not the prevention, of crises.

24. ***Differential terms within the FCL***. The range of FCL qualifiers could be broadened, while preserving safeguards and signaling, by differentiating terms according to the strength of members' policies and fundamentals. Markets would recognize the gradations within the FCL and would assess countries against peer groups rather than viewing the entire FCL membership as a uniform group. However, and crucially, any move in this direction would need to preserve the attractiveness of the FCL to the strongest members. In practice, such

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[14] For additional discussion of the legal implications of some of the proposals discussed in this paper, see *The Fund's Mandate—The Legal Framework*.

[15] A 70 percent majority of the total voting power is needed to establish a special facility with a special commitment fee and other special charges (Article V, Section 8(d)). The majority increases to 85 percent of the total voting power if the special facility would have a repurchase period different than the 3¼- to 5-years applicable in the credit tranches (Article V, Section 7(d)), or if purchases under the facility will "float" against the reserve tranche (Article XXX(c)(iii))—the latter has been a feature of all recent special facilities.

differentiation requires difficult choices—the more so, the finer is the degree of differentiation across country groups. Potential terms to vary include the following:

- **Duration of purchase rights**. Countries with excellent fundamentals and policy frameworks could have automatic access for longer periods without undue risk to the Fund, with this period ranging down for the less strong participants.

- **Access levels**. Residual safeguards could be addressed in part by making access more explicitly a function of the strength of policies and fundamentals—with hard caps for cases involving less strong policies. Any actual financing need above the access cap could be provided subsequently under an SBA. Also, FCL arrangements with countries with some vulnerabilities could be limited to precautionary use, with countries facing immediate balance of payments needs required to use the SBA.

- **Pricing**. Commitment fees and charges within a facility or an instrument could be differentiated on the basis of the strength of the member's policies and fundamentals. However, price differentiation may weaken the public good basis for the Fund's de facto preferred creditor status, as it could be seen as a sign that the Fund is relying on price, rather than on the effectiveness of policy-based financing, for its safeguards.

25. ***Legal implications***. Differentiating access levels and duration of purchase rights for the FCL according to the strength of policies and fundamentals is legally possible. However, given the Articles' current requirement for uniformity in charges, as discussed above, differentiation of charges based on member-specific risk factors would require an amendment of the Articles.

26. ***Precautionary Credit Line*** **(PCL)**. As an alternative to broadening FCL qualification, a new instrument, the PCL, geared to crisis prevention for countries with good policies but still facing some remaining vulnerabilities (for instance, stemming from a currency peg or high dollarization) could be established. As such, the PCL would be less a "new" instrument so much as a special case of HAPA and similar in design to the earlier "RAL" proposals.[16] PCL arrangements would be approved solely on a precautionary basis (i.e., in the absence of an actual balance of payments need) to countries that meet qualification criteria (as with the FCL; pre-qualification could be based on the approaches suggested in paragraph 19) and involve only light ex-post policy conditionality and monitoring. Unlike the FCL, however, countries would be required to commit to a set of policies focused on addressing remaining vulnerabilities, which would need to be monitored. Two approaches could be considered for the monitoring of these commitments:

[16] See *Review of the Fund's Financing Role in Member Countries—Background paper on Proposals for a Rapid Access Line, a Financial Stability Line, and Rapid Liquidity Line*.

i. *Review-based conditionality only*. Policy commitments under the PCL would be monitored through six-monthly reviews, but there would be no performance criteria. Reviews would focus on general progress made by the country on achieving the policy objectives underpinning the arrangement request and continued qualification under the instrument.

ii. *Performance criteria-based conditionality*. Conversely, a limited set of six-monthly quantitative performance criteria could be the *only* basis for program monitoring (i.e., there would be no program reviews). This might appeal to countries wishing to ensure that maintenance of access remains fully under their control, possibly avoiding the stigma of being seen as dependent on Board assessments of their policy performance.

The PCL would provide upfront but capped access, for example, at 500 percent of quota, for rolling six month windows, with the length of arrangements not exceeding 1−2 years. The relative strength of the qualifying members' policies, access cap and the monitoring framework would all contribute to providing the requisite safeguards to the Fund. The establishment of such an instrument is likely to crowd out demand for HAPAs, but would help bridge the current large gap between the FCL and the SBA, facilitating the transition of members toward policies sufficiently for the FCL.

27. ***Legal implications.*** Creating a PCL as an instrument in the credit tranches (with repayments within the standard 3¼−5 years) would require a Board decision adopted by a majority of the votes cast.

Multicountry Swap Lines (MSL)

28. ***Rationale***. A new MSL mechanism to enable the Fund to *offer* liquidity lines (which could either be the FCL or a new dedicated short-term facility) on similar terms to multiple countries simultaneously could help address first-mover problems in systemic crises and attenuate stigma in dealing with the Fund. The purpose of this mechanism is to strengthen confidence and install a firewall around the core of the system to prevent or mitigate the propagation of virulent shocks. Reflecting this purpose, participation would be restricted to countries whose stability is needed to preserve confidence on the global financial markets. Such a mechanism would play a similar and, possibly, complementary role to that played by the Fed and other central banks at the height of the recent crisis. In fact, given the ad hoc nature of central bank swap lines, and uncertainty about the breadth of their availability in the future, a predictable multilateral framework for handling future systemic crises could help mitigate demand for self-insurance in good times.

29. ***Triggering mechanism***. The triggering systemic shock could be a generalized global or regional event, or could be a shock in one country that has spillovers to other countries—for example, a banking crisis in a financial center that raises fears of deposit runs or liquidity pressures in other connected countries. The Fund's unilateral offer would be open for limited term of, say, 3 to 6 months—the very short period would provide needed safeguards that the

member's qualification would not deteriorate in the interim. There would be a presumption, but not a requirement, that the offer would not be renewed so as to induce countries to secure access to the Fund's liquidity lifeline and to avoid facing the difficult situation where the Fund would have to exclude previously qualified countries in the context of a (unilateral) requalification round. Only countries that are assessed to be systemic, in that their stability would help preserve confidence on the core of the global financial system, would be deemed eligible to the MSL. To avoid moral hazard, the countries would also need to have sufficiently strong polices (see below), and the trigger event would need to be exogenous to the recipient countries—or at least of a cross-country nature.

30. ***Procedures***. There would need to be a Board decision on offering liquidity lines to multiple countries at once, which would be publicly announced akin to a government declaration of national emergency. (If the concept of pre-qualification is embraced, the announcement would simply formalize an offer to systemic countries that were earlier identified as qualifying for various facilities.[17]) The Fund would emphasize the unilateral nature of the MSL offer, and reiterate that it was not conveying that any member receiving the offer had approached it for financial assistance. The Fund's unilateral offer would not in itself be a liquidity line to the members; rather, a liquidity line (arrangement) would arise only if the member were to signal its interest by acceptance of the offer, and the Board to adopt a decision (which could be done, if desired, "quietly" by lapse-of-time procedures) confirming that the qualification criteria were met and approving the arrangement.

31. ***Underlying instrument and qualification***. The underlying liquidity line offered to countries could be an existing instrument or a new short-term facility to deal with liquidity shocks. The qualification standards of the underlying instrument would determine the breadth of coverage of the offer, as explained below.

i. *FCL arrangements*. A straightforward application of the MSL would be to offer simultaneous FCL arrangements to systemic countries that are assessed to meet the FCL's qualification requirements (other countries not directly affected by the shock, but found to meet the qualification requirements could still be approved an FCL arrangement following a request by the member). The offer would carry uniform duration and access levels across countries. A drawback of this approach is the very strict qualification requirement embedded in the FCL, which in principle could force exclusion of systemic countries that may benefit from having access to a lifeline. An additional risk is that of tying up Fund resources, given the long repayment period associated with the FCL. Finally, some policymakers have noted their preference to access short-term "swap" lines to deal with liquidity shocks over longer-term credit lines, the latter of which may signal an underlying need for adjustment.

[17] Alternatively, to ensure automaticity, the occurrence of a predetermined exogenous market trigger established in advance by the Board could activate availability of the offer. Use of market triggers has been discussed in different contexts by Cohen and Portes (2006); Buiter and Sibert (1999); and, more recently, Caballero (2009).

ii. *Short-term liquidity lines*. For these reasons, as an alternative to approving multiple FCL arrangements, it may be preferable to provide Fund resources in the form of short-term swap lines that the member would have the option of drawing or not.[18] These would be renewable arrangements of 3- or 6-month duration with a 12- to 24-month repayment period applicable to any resources actually drawn. The shorter drawing window under the new facility relative to the FCL would provide an added layer of safeguard for Fund resources and for containing moral hazard.

32. ***Legal implications***. The Board can adopt the MSL mechanism as a new general policy that specifies the circumstances under which the Fund would offer liquidity lines, the criteria that members would need to meet to be eligible for the offer, and the terms of the lines offered (e.g., an arrangement under the FCL or a new special facility).[19] Consistent with the existing legal framework, including the Fund's Transparency Policy, there would be voluntary but presumed publication of the full list of qualifying members. If a member were to object to publication, the Fund's options would include either omitting the member from the published list, or not publishing a list at all. In the latter event, which would undoubtedly be problematic, the Fund's public announcement could indicate only that a unilateral offer had been made to a group of members of systemic importance, without listing any of these countries. While far from ideal, such an announcement could still provide some assurances to markets during a systemic event.

33. ***Resource implications***. The broader implications of such a policy for the Fund's balance sheet would need to be carefully considered.[20] In particular, given the potentially large take-up in the event of a global crisis, consideration may need to be given to mechanisms for increasing commensurately the Fund's resources available for lending.

Regional Financing and Reserve Pooling Arrangements

34. ***Rationale***. Various country groups have set up regional financing arrangements (RFAs), similar to reserve pooling arrangements (RPAs), to provide insurance to members facing external shocks. Such arrangements include the bilateral swap lines under the Chiang Mai Initiative in Asia and the Latin American Reserve Fund (Box 6). Their development reflects a number of reasons, including regional economic integration and potential dissatisfaction with multilateral pools such as the Fund—although most of them remain linked more or less explicitly to the requirement of a Fund-supported program. A direct

[18] The word "swap" is intended to convey the short-term, ex-post conditionality-free nature of the arrangement rather than the formal swap of asset streams; in a sense, all Fund lending is a "swap" insofar as freely usable currencies are made available in exchange for the member's own currency.

[19] As discussed above, the establishment of special facilities requires a qualified majority (usually 85 percent of the total voting power).

[20] Analysis in an initial paper on the size of the Fund is conducted within the Fund's existing lending mandate.

Box 6. Status of Regional Financing Arrangements

Chiang Mai Initiative (CMI): The ASEAN+3 Finance Ministers introduced the CMI in May 2000 to enhance "self-help and support mechanisms in East Asia."[1] It consists of a network of bilateral swap arrangements to address short-term liquidity difficulties in the region, supplementing multilateral financial arrangements.[2] Under the CMI agreement, the first 20 percent of the amount disbursable to each member is available automatically, while the remaining 80 percent is conditional on adoption of a Fund-supported program. The 3-month swaps can be renewed up to seven times, de facto providing medium-term financing if required. In May 2007, the ASEAN+3 Finance Ministers agreed to take steps toward the "multilateralization" of CMI. Under the new agreement, the aggregate gross amount covered by the swaps has been raised to US$120 billion, with members entitled to make drawings at a multiple of their contributions to the scheme.[3] The new arrangement has become effective on March 23, 2010.

Latin American Reserve Fund (FLAR): The FLAR was created in 1991 as the result of accession of third countries to the Andean Reserve Fund (FAR).[4] The fund operates as a credit cooperative in which the member countries' central banks are able to take out loans, in proportion to their capital contributions, through different credit facilities. Its objectives are to (i) support the balance of payments of member countries by granting loans or guaranteeing third-party loans; (ii) improve the conditions of international reserve investments made by member countries; and (iii) contribute to the harmonization of exchange rate, monetary, and financial policies of member countries. The FLAR has effectively provided short-term financing to its members since its creation, though its subscribed capital remains limited at less than $2.5 billion.

EU Balance-of-Payments (BoP) Facility: Although the European Union does not have a reserve pooling arrangement in place for all its members, its BoP facility introduced by the EC under Council Regulation 332/2002 allows balance-of-payment support to non-Euro area EU members. Over the last year, the facility has been activated for Hungary, Latvia and Romania, in conjunction with Fund-supported programs with conditionality on the "adoption of policy measures to re-establish or ensure a sustainable balance of payments situation." Available resources have been recently raised to EUR 50 billion. The ECB also offers short-term financing to national central banks through the Very Short-Term Financing Facility (VSTF) of the ERM2.

Arab Monetary Fund (AMF): The AMF was created in 1976 by the Economic Council of the League of Arab States and has 22 members.[5] The objectives of the AMF are to correct balance-of-payments disequilibria, promote exchange rate stability and eliminate payment and trade restrictions, promote the development of capital markets, and develop policy coordination. The AMF extends credit to member countries experiencing balance-of-payments difficulties with varying degrees of conditionality; it also extends development project loans. The authorized capital of the AMF is relatively small at $2.7 billion and loans outstanding amounted to $1.1 billion at end 2008.

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[1] ASEAN+3 include Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore Thailand, and Vietnam, plus China, Japan and Korea.

[2] See The Joint Ministerial Statement of the ASEAN + 3 Finance Ministers Meeting and The Joint Ministerial Statement of the 8th ASEAN+3 Finance Ministers' Meeting

[3] See Henning (2009).

[4] FLAR members include Bolivia, Colombia, Costa Rica, Ecuador, Peru, Uruguay and Venezuela.

[5] Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, West Bank and Gaza, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, UAE, Yemen.

financial involvement by the Fund with these arrangements could help overcome some of their limitations, including their potential ineffectiveness in dealing with region-wide or global shocks, their relatively small resources, and the potentially weak enforcement under peer-monitoring (surveillance) arrangements, which hampers the signaling effects of RFAs or RPAs. Channeling Fund resources concurrent with activation of RFA/RPA financing could also be a powerful way to reduce stigma, particularly if such activation involved multiple countries at once.

35. ***Financing***. The Fund could top up overall resources by (a) co-financing through bilateral lending to individual RFA or RPA members in appropriate circumstances (via SBA, FCL, or possibly PCL and MSL arrangements); or (b) lending directly to RPAs. The latter would be most appealing to countries that most associate stigma with Fund lending, but would require a greater degree of risk-sharing by the members of the pool (who would be collectively responsible for repayments to the Fund) than under the co-financing model.

36. ***Legal Implications***. Financial backstopping of RPAs through co-financing can be provided within the Fund's existing legal framework. The normal requirements for GRA financing would apply (e.g., uniformity of treatment, balance-of-payments need for drawings, safeguards), as well as the requirements under the particular instrument under which financing is to be provided. Any GRA lending directly to an RPA would require an amendment of the Articles, as GRA financial support can only be provided to members. However, the Fund could use SDA resources for this purpose, so long as the lending is for the benefit of Fund members, for balance of payments assistance, and is provided under a policy that meets uniformity of treatment requirements. The Fund could also establish trusts to administer resources provided by third party contributors for this purpose.

V. Conclusions and Issues for Discussion

37. **This paper has considered various options for modernizing the Fund's financing role, based on an assessment of the recent crisis and extensive input from stakeholders**. The Fund was established with the mandate to provide an effective global financial safety net to help countries cope with external volatility. The Fund's capacity to meet this mandate must remain under constant review. The deepest global crisis in a generation offers key insights on areas for further enhancements of the financing role of the Fund. The crisis has heightened countries' perception of vulnerability to shocks and their demand for crisis insurance. It has also exposed the inadequacy of the current global financial safety net to deal with contagion in systemic events. And, despite earlier reforms to reduce the strings attached to Fund lending, discussions with policymakers and private sector representatives have highlighted the pervasive nature of stigma attached to the Fund.

38. **Further reforms of the Fund's financing role should therefore focus on crisis prevention and the management of systemic crises**. The development of precautionary lending instruments and multicountry mechanisms to stem contagion in systemic crises will enhance the Fund's role as anchor to global stability. Mitigating incentives for reserve

accumulation requires backing Fund lending with adequate resources while increasing its automaticity and predictability. Doing so, however, could exacerbate moral hazard. To avoid this, lending terms (size, duration, and price) and policy conditionality could be made more explicitly and transparently a function of the strength of borrowers' fundamentals and policies. To this end, consideration could be given to including assessments of qualification to lending instruments routinely in Article IV reports. Such steps, together with ongoing efforts to improve Fund governance, would help alleviate stigma attached to Fund lending.

39. **All things considered, a balanced set of reforms making significant improvements to the Fund's toolkit, while not requiring changes to the Articles, include** (Table 1):

- **Enhancing bilateral credit lines**: (i) enhance the FCL's usability by lengthening its duration, streamlining qualification criteria, and uncapping access; (ii) adapt High Access Precautionary Arrangements to create a new Precautionary Credit Line providing upfront but capped access to Fund resources with light policy monitoring for countries with good policies and fundamentals but that do not qualify for the FCL.
- **Establishing a Multicountry Swap Line mechanism for systemic crises** to enable the Fund to *offer* financial assistance to systemic countries with good fundamentals that face short-term liquidity pressures during systemic events.
- **Backstopping regional financing and reserve pooling arrangements** by offering pari passu co-financing via Fund arrangements (FCL, PCL, or SBA) for individual members, as appropriate within the terms of these instruments.

40. **Directors' views on the following specific issues would be welcome**.

- *Do Directors agree that experience from the current crisis indicates that a stronger international financial safety net is needed, including as a means to limit overreliance on reserve accumulation?*
- *Do Directors agree that further lending reforms should focus on the effectiveness of instruments for crisis prevention and for dealing with systemic events?*
- *Along what dimensions should the FCL be improved? Would Directors support signaling qualification though summary statements in Article IV reports?*
- *Should members' access to FCL-style credit lines be broadened by differentiating terms within the FCL, or should consideration instead be given to creating a new crisis prevention instrument along the lines of the PCL?*
- *Do Directors concur with the need for a multicountry offer mechanism to stem contagion in a systemic crisis? And what should be the underlying instrument offered: the FCL or a new short-term liquidity line?*

- *Do Directors believe the Fund should aim to support more explicitly regional financing and reserve pooling arrangements and in what form?*

Table 1. Core Reform Options

Instrument	Purpose	Reform Option	Key Legal Implication
Flexible Credit Line (FCL)	Enhance predictability of qualification	• Streamline current qualification criteria • Signal qualification in Article IV reports • Adopt rule-based “Maastricht-like” criteria	Amend FCL Decision (may also require changes to other decisions) (majority of votes cast)
	Increase automaticity	Double duration of purchase rights from 6 to 12 months	Amend FCL Decision (majority of votes cast)
	Eliminate access cap	Remove implicit 1000 percent of quota cap	Clarify via new summing up (majority of votes cast)
	Reduce cost	Reduce commitment fee for FCL only	Convert FCL into special facility and show lower expenses for FCL arrangements (at least 70 percent of total voting power)
Other FCL-style Credit lines	Enhance precautionary instruments for countries that do not qualify for the FCL	Broaden qualification and differentiate FCL terms according to countries’ policies by • duration or access • pricing	• Amend FCL Decision • Amend Articles
		Create precautionary credit line (PCL) • Upfront but capped access • Light ex-post conditionality/monitoring	Adopt Board decision (majority of votes cast)
Multicountry Swap Line	Strengthen effectiveness in responding to systemic shocks	Create mechanism to offer liquidity lines (limited-time window of 3 to 6 months) to qualifying “systemic” countries at once	Adopt new policy to specify when the Fund would offer credit lines (majority of votes cast)
		• Approve multiple FCL arrangements on uniform terms to qualifying countries, or • Adopt facility for systemic liquidity pressures (6 months arrangement; repayment in 12−24 months). Qualification based on good policies	• No change needed • Establish new special facility (85 percent majority of voting power)
Regional Financing /Reserve Pooling Arrangements (RFAs/RPAs)	Backstop RFAs/RPAs to complement Fund lending, alleviate stigma	• Co-finance RFAs/RPAs’ bilateral lending • Lend directly to RFAs/RPAs	• No change needed • Amend Articles or use of SDA or donor resources

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