In times of plenty, IMF prepares for rainy day

The IMF is weighing a new financing instrument designed to help prevent confidence crises in emerging market countries by providing a line of contingent financing. The need for a new loan instrument designed specifically with emerging market countries in mind was proposed as part of Managing Director Rodrigo de Rato's medium-term strategy, which seeks to improve the IMF's ability to meet the needs of its member countries in today's globalized world.

Bank of Italy

The IMF's First Deputy Managing Director, John Lipsky (right), consults with the Director General of the Bank of Italy, Fabrizio Saccomanni, during an outreach event in Rome on December 14. The meeting, attended by a mix of country officials and academics from 16 African, Middle-Eastern, and European countries, saw a lively discussion of the pros and cons of the Fund's proposed new credit line for emerging market countries.

The increased mobility of capital has allowed rapidly growing emerging market countries to tap into global savings to satisfy their considerable need for investment capital. But past experience has demonstrated that such funds may be withdrawn at a moment's notice for reasons that may not be closely related to the country's economic performance. The sudden withdrawal of funds—driven by a loss of confidence and contagion effects—can have devastating effects on countries, but might be avoidable. It therefore makes sense to consider whether there is a role for the public sector to address what is, in essence, a market failure.

Over the past decade, emerging market countries have improved their policies and increased their reserves. The IMF is supporting this effort on the policy front by improving its surveillance (shorthand for its monitoring of economic developments and policies) and standing ready to make high-access financing available in the event of a crisis. This may reduce the need for emerging market countries to accumulate reserves, which—from a purely economic perspective—may not constitute an efficient use of scarce resources.

A missing tool

A number of emerging market and other countries have suggested that the IMF's tool kit may be missing an item—an instrument that could provide contingent financing that countries with strong policies can tap into to help prevent crises or reduce their cost. In the current favorable environment of abundant liquidity and robust growth, however, it is quite likely that potential users may not seek access to a new contingent financing instrument in the near future. Nevertheless, it is prudent for the IMF to consider its member countries' potential needs so that it is ready to provide assistance when market conditions may be less favorable than they are now.

The new instrument under consideration would broadly share the objectives of the Contingent Credit Lines (CCL), the IMF's previous instrument for contingent financing, which expired in 2003 without ever being used, and draw on the lessons learned from the CCL's lack of success. Several possible problems have been identified. The lack of automaticity of drawings and the small scale of the initial loan amount raised doubts about the usefulness of the facility. Members were also concerned that investors might perceive a country's decision to apply for the CCL as an indication of unseen vulnerabilities and that losing eligibility would send a negative signal. It is hard to know which of these concerns played the larger role in discouraging use of the CCL, but it is possible that they might not have resulted in the instrument's demise if a country meeting the eligibility requirements had requested its use.

A paper prepared by the Policy Development and Review Department provided the basis for a discussion at the IMF's Executive Board in August 2006. The IMF staff is now in the process of seeking views on what role a new instrument might play and on an appropriate design that could find broad support among its members. In particular, the staff is seeking to clarify how a new instrument could balance the need for rapid access to funds with safeguards to reduce the risks of rapidly available financing. Following a successful discussion of the issue with policymakers in Korea in August 2006, two more seminars were held, in Chile and Italy, in December. The staff is also seeking input from market participants. The work on a new instrument remains at an early stage, however, and further discussions by Executive Directors will be held this year.

A possible design

The overarching goal for a new instrument is to help prevent capital account crises. This could be achieved through two channels. First, the instrument could lower incentives for private investors to rush for the exit by providing assurances that large-scale financing would be available for countries hit by shocks. Second, it could help countries reduce underlying economic vulnerabilities by reinforcing their commitment to implement sound policies. Designing a lending instrument to achieve these two objectives involves trade-offs that have to be carefully balanced. A successful design should aim to combine the following elements:

• *Financing should be large enough to help prevent a crisis and should be readily available.* Inadequate financing or insufficient assurances about the availability of Fund resources in the event of a crisis would reduce the effectiveness of a new instrument for crisis prevention—although large financing creates risks for the Fund.

• *Measures to safeguard the IMF's resources will be necessary.* Adequate safeguards need to be included in the design of the new instrument to properly address the risks implied by a commitment to provide rapid financing if a crisis emerges. Such safeguards could take the form of prequalification standards to limit eligibility to a group of countries with strong policies, follow-up monitoring by the IMF of policy commitments made by countries, or a combination of both.

• *A framework for monitoring economic policies should be designed to provide incentives for good policies that countries are fully committed to implementing.* Such incentives could stem from qualification standards that countries aim to achieve and maintain over time, or from policy commitments that are monitored in the context of the new financing instrument. Some believe that conditionality (agreements on policy changes that countries adopt to ensure their continued access to funds) under traditional IMF arrangements is excessive, and a different structure may be considered to make certain that IMF resources are protected.

• *The negative signals associated with either requesting a credit line or failing to qualify for its renewal should be limited to the extent possible.* Some countries were concerned that requesting a CCL would be interpreted as a signal of vulnerability, a problem that contributed to the earlier facility's demise. To avoid similar problems in the future, it may be advisable for countries to request a credit line before they see an imminent risk of crisis. Countries' concerns about an adverse market reaction in the event the IMF decides to discontinue access to its funds (because of deteriorating economic conditions or policies) can never be fully eliminated but could be mitigated by avoiding sending overly blunt exit signals in the context of contingency lending arrangements.

Inadequate financing or insufficient assurances about the availability of Fund resources in the event of a crisis would reduce the effectiveness of a new instrument for crisis prevention—although large financing creates risks for the Fund.

Controlling risks

Any financial engagement between the IMF and a member country carries risks that must be carefully assessed and controlled. In the context of a new crisis prevention instrument, such risks include lending without proper policy adjustment by the member country following a crisis, and moral hazard problems that encourage reckless lending by the markets and by member countries.

The first problem could be addressed through prequalification criteria that would be valid only for a limited time, a close relationship between the IMF and the member country following qualification, and discussions with the Executive Board once the country has accessed the instrument. Moral hazard on the part of a country's authorities would likely be avoided by the enormous costs of a crisis—even if substantial Fund financing softens its impact. Reckless lending by private creditors may be limited because of markets' previous experience with losses during financial crises. ■

Peter Breuer and Alan MacArthur
IMF Policy Development and Review Department

Copies of *Consideration of a New Liquidity Instrument for Market Access Countries* are available for $15.00 each from IMF Publication Services. See page 16 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).