INTERNATIONAL MONETARY FUND

Review of the Fund's Financing Role in Member Countries

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In consultation with other departments

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I. Introduction [1]

1. This paper raises and discusses issues related to how the Fund provides financial assistance to its members. It is part of the strategic review to ensure the Fund remains relevant and effective. The objective is *not* to increase Fund lending, but to make sure the Fund has the right instruments and policies to help all of its members—with appropriate protection of Fund resources—as they integrate into a world of growing and increasingly complex cross-border flows. Other institutions (including major central banks and the World Bank) also are retooling their lending instruments and in the process grappling with similar issues. The paper offers a high-level view of the issues and does not make specific policy proposals. Policy proposals will be presented in follow-up papers, some of which are planned for Board discussion later in 2008.

II. Members' Needs and the Services Provided Through the Fund's Instruments

2. Article I states that one purpose of the Fund is "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." This activity has benefited the global system as a whole as well as all members, indirectly or directly. About four out of five Fund members have used Fund credit at least once (Table 1), although use has been more concentrated since the 1980s.

3. The global financial system has evolved enormously since the Fund was created, and so have members' needs for Fund support. Over time, and in stylized brush strokes, Fund financial assistance has gone from helping to smooth the effects of short-term (seasonal) trade fluctuations to supporting adjustment (and catalyzing financing) to a wide range of actual or potential balance of payments problems, resulting, inter alia, from terms of trade shocks, natural disasters, post-conflict situations, broad economic transitions, poverty reduction and economic development, sovereign debt restructuring, and confidence-driven banking and currency crises.

4. The Fund has adapted to members' evolving needs, but change has been mostly in the form of adjustments to a structure of lending developed half a century ago. (Table 2 lists current Fund facilities and instruments). The stand-by arrangement was established in 1952 and, though its use has been declining, it has remained the workhorse for middle-income countries that seek financial assistance. Under its structure, financing is provided in support of adjustment to a balance of payments need and disbursed in tranches (phasing) based on

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[1] Prepared by Mr. Erickson von Allmen, Mr. MacArthur, and Ms. Gust, with input from Ms. Alonso-Gamo and Mr. John.

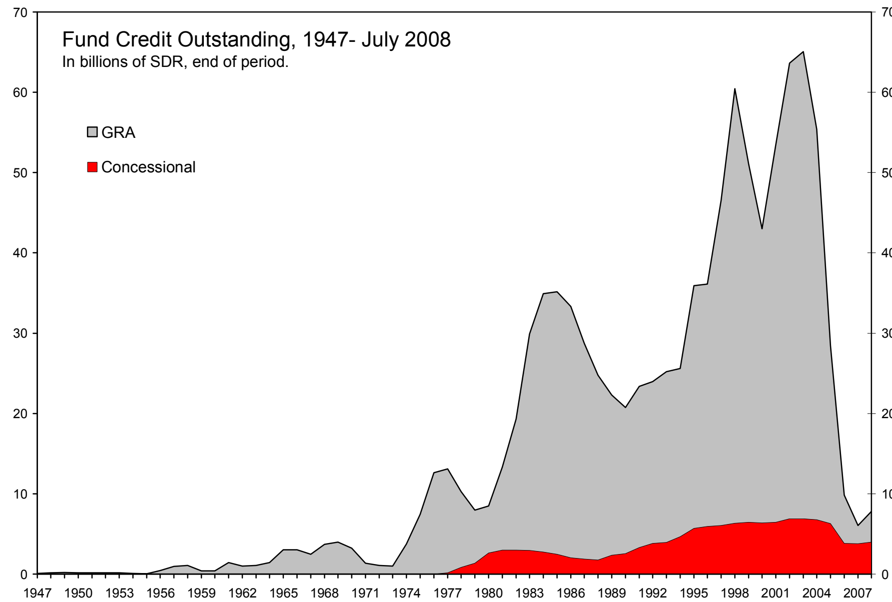
conditions. Other facilities have been developed on this model, including concessional balance of payments support for low-income members. Since 1999, the Poverty Reduction and Growth Facility (PRGF) has been the primary vehicle for such assistance. In a few areas, where financing is small, and related to exogenous shocks or the particular needs of post-conflict countries, phasing is not required and a sensible policy statement suffices as conditionality. The Fund can also make available outright purchases in the credit tranches, but in recent years outright purchases have been used only under the policy of emergency assistance.

5. The model of financing in support of adjustment to a balance of payments need will remain an integral element of the Fund’s toolkit, but should not be a straitjacket that prevents the Fund from tailoring its services better to members’ circumstances and demands. As members strengthen their policies and gain deeper and more secure market access, their need for traditional, phased adjustment-based balance of payments support declines, while their need for support to maintain confidence, and to cope with shocks, risks, and vulnerabilities rises. This inherent feature of economic development has been reinforced in recent years by plentiful global liquidity, and it affects both middle- and low-income countries. While the liquidity cycle may be reversing, it has exposed how tilted the structure of Fund facilities is toward the phasing-and-conditionality model, and that a rethink of the lending model and the taxonomy of Fund instruments is needed.

6. Looking ahead, as financial integration deepens, crises are more likely to arise from global shocks and unfold more quickly and in a more contagious manner than in the past. Integration into capital markets carries with it exposure to shifts in investor sentiment, sometimes caused by doubts over the direction of the member’s policies or vulnerabilities. The turmoil in financial markets in advanced countries shows that risks can originate and propagate there. Members that may still be classified as low-income will increasingly be experiencing the kinds of issues that have hitherto been faced only by emerging market countries, and they will demand services to meet these needs. Others will no doubt experience balance of payments needs similar to the past. Recent oil and food price hikes have been a reminder that members remain exposed to terms of trade shocks.

III. Recent Developments and Challenges for the Fund

7. The demand for the Fund's general resources has dropped sharply in recent years, along with a more modest decline in the demand for the Fund's concessional resources.[2] In the recent period of ample global liquidity and strong growth, many members have strengthened their policy frameworks and reduced vulnerabilities, and there has been little need for balance of payments financing. Many low-income members have also received substantial debt relief, seen a pick-up in private capital inflows, and benefited from new sources of official financing. Still, few Fund members are immune to a major change in global conditions.



8. Does the decline in use of Fund credit point to a problem? One view is that it does not: the Fund is and should be a lender of last resort and, in the event of a crisis it is still the institution best suited to provide and orchestrate relevant financial packages. Low demand for exceptional financing should be expected when balance of payments needs are historically low, and strengthened balance of payments positions could be viewed as a sign of success, reflecting the adoption in many countries of policies long advocated by the Fund.

9. Another view is that there is indeed a problem. While a decline in demand for Fund lending is natural and welcome, many members seem to shun the Fund. Indeed, many seek solutions to balance of payments-related needs, risks, and contingencies from sources outside the Fund. A few examples:

[2] In this paper, though legally imprecise, the terms "instrument," "arrangement," and "facility," are used interchangeably. Also, the Policy Support Instrument (PSI) is formally a technical service, but it is considered with lending instruments in this paper because of its signaling and monitoring roles.

Insurance

- Members are increasingly promoting regional reserve pooling and financing arrangements (such as the Chiang Mai Initiative, the Latin American Reserve Fund, the European Union and the European Central Bank), though these remain largely untested in crisis.

- Many are building substantial international reserves for self-insurance and other reasons; for some reserves have reached levels that are high by most metrics.

- A number of members are using or exploring the contingent financing offered by the World Bank in the form of a Deferred Drawdown Option in conjunction with adjustment loans.

Advanced country liquidity smoothing/crisis prevention

- Several central banks rely on bilateral swap lines for liquidity management. For example, in the credit market turmoil in advanced economies, the U.S. Federal Reserve has extended swap lines to the European Central Bank and the Swiss National Bank.

- In May 2008, the central banks of Sweden, Norway and Denmark entered into a Euro/Icelandic krona swap facility agreement with the Central Bank of Iceland.

Other official balance of payments-related financial assistance

- At least two members have engaged in collateralized borrowing from the Bank for International Settlements for what could be described as balance of payments purposes.

- Several members are exploring development policy loans from the World Bank that have some characteristics of balance of payments support, but with much longer repayment periods and a somewhat lower interest rate than the Fund and with conditionality tied only to an appropriate macroeconomic policy framework.

10. While these developments are not all new, they do raise questions about the role of the Fund and the Fund's mandate as a provider of cross-border financing and about gaps in the Fund's toolkit. Do members have balance of payments needs or risks for which the Fund does not offer attractive solutions? For example, the accumulation of reserves and the regional pooling initiatives reflect several objectives, one of which is a desire to build defenses against crisis (and for some, no doubt, against having to come to the Fund). While these initiatives can complement Fund financing, a basic premise for the Fund's existence is that there are advantages to broad multilateral pooling. Furthermore, could there be a role for the Fund along the lines of central banks' swap transactions? And if official balance of payments financing or protection is needed, what role should the Fund play?

11. Some argue that the Fund's pool of resources has become too small for its lending to be relevant to a large segment of the membership, that the Fund's instruments do not provide the services members seek, send negative signals (see Box 1), come with too many conditions, too little financing, and are too costly. If so, what can and should the Fund do to address these concerns?

Box 1. Concerns About Stigma

One reason members may hesitate to approach the Fund is because of the stigma they associate with Fund-supported programs. While a certain amount of stigma may be inevitable for an institution that helps members when they get into trouble, too much can interfere with the Fund's effectiveness if it keeps members from approaching the Fund until a crisis is well underway. Stigma also makes it harder for the Fund to play a role in crisis prevention.

The source of stigma varies. It depends partly on the member's past Fund experience. Stigma can be linked to concerns that approaching the Fund will be seen as a sign by markets that problems are worse than thought, or to domestic political concerns, which in turn can be linked to broader concerns over conditionality. Low-income countries may fear that use of the PRGF, the Fund's primary concessional lending instrument, could give the impression of not being well-advanced in terms of development or of debt sustainability risks, given the PRGF's association with the HIPC Initiative for debt relief. In accepting the role as scapegoat for necessary but unpopular reforms, the Fund adds to stigma. The stigma also worsens when the Fund's credibility is tarnished.

Many central banks also grapple with stigma.[1] For example, in 2007, the U.S. Federal Reserve struggled to alleviate the stigma effect that deterred banks from using its discount window. As the credit crisis unfolded, the Fed cut the discount rate (and the target federal funds rate), loosened collateral standards to make it easier for banks to use the discount window, and created a new facility (the Term Auction Facility). A coordinated approach to the discount window by four large financial institutions was intended to help de-stigmatize its use. Furthermore, the Bank of England recently established the Special Liquidity Scheme which seeks to tackle stigma by prohibiting the publication of information about who has used it and in what amounts.

It is difficult for the Fund to tackle stigma directly, but the problem can be alleviated (or partly offset) by tailoring instruments better to the needs of members. One question, discussed below, is whether there is a role for a "quiet" Fund facility.

[1] See, for example, Central Bank Operations in Response to the Financial Turmoil, Committee on the Global Financial System Paper No. 31, July, 2008, Bank for International Settlements.

IV. SOME BROADER ISSUES REGARDING FUND LENDING

12. Against this background, and before moving into a discussion of possible options for retooling, it is useful to consider some principles underpinning the Fund's lending.

The rationale for Fund lending today

13. Is there a rationale for Fund lending today? Although the world has changed enormously since the Fund was created, Article I provides a broad framework for Fund lending that continues to be relevant. Through its lending function the Fund promotes important international public goods such as balance of payments stability and an open system of international trade and exchange, and reduced externalities in the form of contagion from crisis, disruptive adjustments, and defaults:[3]

- Fund financing helps smooth adjustment to various shocks, and thereby helps the member avoid overly disruptive economic adjustment or default that can be costly to the member itself and others via contagion. With increasing financial integration, the nature of balance of payments needs and risks for many members is changing, however, with implications for where and how Fund financing is best provided. It is even raising questions about the relevance of the balance of payments concept as the basis for Fund lending (see below).

- Fund-supported programs can also help unlock other financing—the catalytic role. For the member, the program's conditionality and signal (stamp of approval) can help reinforce policy credibility ("tying one's hands") and thus increase investors' confidence in the direction of economic policies. This is true even when the Fund's own financial contribution is small. From the perspective of creditors, official and private, they benefit from having conditionality and monitoring of country macroeconomic policies undertaken by a central, multilateral institution. (As a result, however, the Fund often has been put, *nolens volens*, in the role of gatekeeper, and members in need of support have come to the Fund even if they might have preferred otherwise.) At the same time, some argue that the Fund's catalytic (signaling) role is not as important today as it used to be, and that the Fund's conditionality has become excessive.

- Fund lending can help prevent crisis. The experience is clear: capital account crises typically inflict substantial costs on the member itself and other countries through spillovers. And the best way to deal with capital account instability is to nip it in the bud before it develops into a full-blown crisis. By making available large access up front in support of strong policies, the Fund can help improve confidence in the member's policies and reduce the incentive for investors to run for the exit at the first signs of trouble. However, the Fund's current instruments are not ideally suited for this type of support (see below).

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[3] For a discussion of these issues, see Reflections on the Function and Facilities for IMF Lending, September 23, 2005, by Michael Mussa, available at www.iie.com.

14. The private sector cannot be counted on to provide these services, and it is difficult for any bilateral creditor to do the same, because of the costs involved, resources needed, legitimacy concerns, and because it is politically difficult to make the hard decisions that are sometimes necessary. With its professional expertise and multilateral and cooperative mandate, the Fund has a comparative advantage.

How should this lending be provided—the role of conditionality?

15. Most Fund lending is disbursed in tranches and subject to conditionality, and for good reason. Phasing and conditionality are intended to ensure that balance of payments problems are resolved in a manner that is not destructive to national or international prosperity and limits the risks to the Fund. Phasing allows the member time to undertake required adjustments, while conditionality can reinforce the program's credibility, catalyze other financing, and speed the return of confidence in a crisis. Indeed, oftentimes members themselves want to establish conditionality as a way of signaling policy commitment. More generally, program conditions provide the member with clear markers about what it needs to do, and not do, for the program to remain on track, and for it to be able to draw.

16. But is the Fund overdoing conditionality? Many observers see conditionality as heavy handed, undermining ownership, and, in the extreme, interfering with sovereignty.[4] In response, the Fund has rewritten its guidelines to ensure conditionality is applied judiciously.[5] The problem is that it is often difficult to separate what is critical to program success from what is just good, a problem that is magnified if there is a lack of clarity about the program objectives. For an institution focused on helping members, and with an ethos built around fixing problems, conditions easily can become applied to measures that are worthwhile but not critical. As members develop and seek different services from the Fund, a broader question is whether, staying within the principle of uniformity of treatment, conditionality can be tailored

[4] Raghuram Rajan has linked the expansion of conditionality to the segmentation of Fund lending: When every member was a potential borrower, conditions were applied mostly to exchange rate and macroeconomic policies, but as the Fund began lending mostly to developing and emerging market economies, it began to place conditions on structural reforms that are more intrusive. In a similar vein, a recent paper argues that as Fund membership became more heterogeneous over time, the Fund has become increasingly unlikely to provide financing on a sufficient scale to meet the demand of higher-risk members (Dealing with Country Diversity: Challenges for the IMF Credit Union Model, by G. Irwin, A. Penalver, C. Salmon, and A. Taylor, Bank of England Working Paper No. 349, May 2008.)

[5] See: Guidelines on Conditionality, Decision No. 12864-(02/102), September 25, 2002, and the recent Implementation Plan in Response to Board-Endorsed Recommendations Arising From the Independent Evaluation Office's Evaluation of Structural Conditionality, April 8, 2008. Conditions are meant to be used sparingly, be focused on the Fund's core areas, and be applied only to variables or measures that are critical to achieving program goals or monitoring implementation of those goals, or that are necessary for the implementation of specific provisions in the Articles of Agreement and policies thereunder.

to fit better members' varying circumstances or if there are circumstances where a different model (i.e. not based on conditionality) could be used.

What should be the basis for Fund lending?

17. All Fund financing is committed on the basis of actual or potential balance of payments need. Article V, Section 3 stipulates as one condition for drawing that a member "represents that it has a need to make the purchase because of its balance of payments or its reserve position or developments in its reserves". But financial market liberalization and integration is making the distinction between resident and nonresident transactions, which is central to the definition of balance of payments, increasingly irrelevant from an economic point of view. Open capital accounts and globalization have led to the development of active secondary markets for debt, enabling debt instruments to move rapidly across borders. Already, questions about balance of payments need have arisen when Fund financing is directed toward the budget (as in currency unions, currency boards, or when it helps the government deal with a domestic funding problem) or when it is used to help support a domestic lender-of-last-resort function in foreign currency. While such financing is justified on grounds that problems in the government or banking sectors are associated with existing or potential balance of payments problems, the need criterion can be difficult to specify in practice. A question, therefore, is whether the Fund should consider modernizing the way balance of payments need is defined.

How should Fund lending be organized?

18. Could the Fund provide all of its assistance under only one facility? This is a natural question when Fund instruments are discussed, and indeed some have considered this possibility.[6] A single-facility structure would be simple and transparent. But in order to address individual circumstances, the terms (including concessionality) would need to be tailored to members' balance of payments needs and economic circumstances, and such tailoring may not be operationally much different than simply having different facilities. Also, a multiplicity of instruments may not represent any real cost to the Fund, and can allow the Fund to tackle special balance of payments problems faced by a small number of members, in a way that does not undermine other operations.

19. With multiple facilities the challenge is to ensure that the taxonomy of instruments is relevant to members' balance of payments needs.

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[6] See, for example, Simplification of IMF Lending—Why Not Just One Flexible Credit Facility? by M. de Las Casas and X. Serra, Banco de España, April 2008, available here. Another recent paper that also raises this question is Review of the IMF's Lending Framework, by J. Caroline and V. Evelien, August 2008, National Bank of Belgium (internal paper, preliminary version).

- For low-income members, the Fund has instruments for signaling and monitoring where others provide financing, for emergency and shocks assistance, and for long-term balance of payments financial assistance (see Table 2). One question is how the Fund can best meet these members' short-term balance of payments financing needs (see discussion in the next section).

- A bolder rethink might be needed for what is offered to advanced and emerging market members. Fund financing, as it exists now, is not being used by advanced members, and is rarely used by emerging market members, although this could change, and the Fund should be willing to explore new forms of assistance for them. These members do not have long-term balance of payments needs for which they require Fund assistance, and the stand-by arrangement is highly flexible, and will continue to be an appropriate instrument for many members with short and medium-term balance of payments needs. As discussed further in the next section, what seems to be missing for them, though, are a pure signaling and monitoring instrument, an instrument designed specifically to reduce the risk of capital account crisis, and an instrument that can provide very short-term foreign exchange liquidity. For instance, it is noteworthy that central banks (in more advanced economies) can experience substantial short-term foreign exchange liquidity needs—which is only loosely linked to balance of payments need—that they cover through swap arrangements with other central banks. Hitherto the Fund has tacitly eschewed any role in such transactions, but why should it be self-evident that there could not be a role for the Fund?

20. Another question is whether the Fund could be more active, including through its lending, in helping develop markets for hedging instruments against capital flow shocks.[7] Such insurance instruments, despite their potential value, are not used widely in part because relevant markets are underdeveloped. Could the Fund, perhaps together with regional reserve pools, play a role in contingent instrument market development?

V. Some Ideas for Retooling

21. In light of the above, while the rationale for Fund lending seems incontestable, the shifting nature of members' needs suggests that some re-tooling should be considered for the Fund to be able to provide relevant support to all members. With demand for PRGF arrangements still relatively strong, and much of the decline in PRGF use matched by an increase in PSIs, issues related to the Fund's program support in low-income members could be addressed with a set of targeted reforms. For other members, a bolder reform of legacy structures may need to be considered. Again, the purpose should not be to increase lending,

[7] See, for example, The Future of the Fund, by Ricardo Caballero, American Economic Association Papers and Proceedings, May 2003.

but to ensure the Fund's lending apparatus is up to date and relevant to all members. To this end, this section looks at the following areas: (A) the set of instruments; (B) the modalities for conditionality and safeguards; (C) the size of the Fund's general resources and associated access limits; and (D) the cost of Fund credit.

A. Fund Lending Instruments

22. New facilities have been added over the years and, despite the occasional cleanup, this has led to a proliferation of instruments. Some of them overlap, which can be confusing to members and the public, at the same time as certain balance of payments needs are left unaddressed, which is problematic. Redundant instruments should be eliminated, and gaps in the toolkit addressed.[8] Several potential gaps in the toolkit may be explored: (i) a pure signaling instrument; (ii) a credit line designed to help forestall capital account shocks; (iii) a liquidity instrument for fast drawings of short maturity; and (iv) a "quiet" instrument. These are discussed below; support specific to low-income members is discussed later.

23. *A pure signaling instrument.* Today the only option for a middle-income member interested in the Fund endorsing and monitoring its policies purely for signaling purposes is to request a stand-by arrangement and treat it as precautionary. Precautionary arrangements have a good record of use by members, and their signals are well understood. For these and other reasons, when the PSI was created, it was limited to low-income members so as not to undermine precautionary arrangements. At the same time, it is awkward that a member has to request a financing arrangement when they do not want any financing. In such cases, there is pressure to find the lowest possible access that will allow for a credible signal (access above the first credit tranche to allow upper-credit tranche conditionality), while minimizing the commitment fee. The Fund could consider making the PSI available to all members, or creating a signaling instrument similar to the PSI for middle-income members.

24. *A crisis-prevention instrument.* When integrating into global capital markets, members are rightly concerned about the possibility of capital account shocks. It is widely agreed that there is a case to explore instruments that can help prevent a capital account crisis, since their cost is so high. Currently, members interested in a precautionary line of defense that provides meaningful financing and a boost to policy credibility could request a high access precautionary stand-by arrangement (as Brazil did in 2003). But with its quarterly phasing and inherent on-off pattern for availability of financing, the stand-by is not ideal for this purpose.

25. The Fund has been considering for some time the creation of a new liquidity instrument (such as the Rapid Access Line, or RAL) specifically designed to fortify members'

[8] In 2000, the Fund undertook a comprehensive review and reform of its facilities. See: Review of Fund Facilities, November 30, 2000.

defenses against capital account crisis.[9] The challenge has been to find a design that strikes the right balance between being attractive to potential users and providing adequate safeguards to the Fund. While there is broad agreement on many important design features, progress on the RAL has been delayed concerns over some design tradeoffs and the first mover problem, and the fear of creating an instrument that goes unused. There has been no clear indication of demand from potential users. In the meantime, two Executive Directors have sketched out a liquidity instrument with objectives and design that are similar to the RAL but with some innovations. Their Financial Stability Line (FSL) would focus on countries that announce a program of strengthening the regulatory and supervisory framework, developing domestic financial markets, and gradually liberalizing the capital account—developments that could increase vulnerability to crisis.[10] The RAL would focus more on countries that already have achieved a meaningful degree of capital market integration and that do not have large reform needs. Although there are some tradeoffs between the two proposals, there is no reason why a new liquidity instrument could not embody much of both the FSL and the RAL. Perhaps a name change is also needed.

26. *A short-term liquidity instrument.* The more advanced Fund members can experience periods of turbulence—indeed many do now—when they need short-term foreign exchange liquidity at short notice. These countries typically rely on foreign exchange swaps with other central banks, and do not come to the Fund. The President of the Federal Reserve Bank of New York recently proposed that, to make the global financial system more resilient, the big central banks should put in place a standing network of currency swaps, collateral policies and account arrangements that would make it easier to mobilize liquidity across borders quickly in a crisis.[11] The recent swap lines from central banks providing liquidity for Iceland represent another example.

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[9] The Board has discussed crisis prevention instruments on several occasions in recent years. See: Further Consideration of a New Liquidity Instrument for Market Access Countries—Design Issues, February 13, 2007; Consideration of a New Liquidity Instrument for Market Access Countries, August 3, 2006; Country Insurance: The Role of Domestic Policies, June 19, 2006; Fund-Supported Programs and Crisis Prevention, March 23, 2006; Precautionary Arrangements—Purposes and Performance, March 23, 2006; Crisis Prevention and Precautionary Arrangements—Status Report, September 3, 2004; Completion of the Review of Contingent Credit Lines and Consideration of Some Possible Alternatives, November 12, 2003; Adapting Precautionary Arrangements for Crisis Prevention, June 11, 2003; Review of Contingent Credit Lines, February 11, 2003.

[10] The supplement to this paper describes the RAL and the FSL.

[11] "We Can Reduce Risk in the Financial System", by Timothy F. Geithner, Financial Times, June 9, 2008.

27. Perhaps along these lines, the Fund might consider establishing a quick-disbursing short-term liquidity facility. Under such a facility the Fund could provide support in the form of one outright purchase. It could be available to members with very strong policy track record and a sound policy framework. The structure of this facility could allow for a quicker response to foreign exchange liquidity pressures than when a full-blown program has to be negotiated. The primary safeguard to the Fund would be the selective qualification assessment. This facility could make the Fund a place where illiquid but solvent members can draw on temporary foreign exchange liquidity as a normal part of their business, a role close to Keynes' vision for the Fund back in 1945. Such a facility would require careful consideration of the implications for Fund liquidity and about the design of appropriate safeguards to the Fund (including eligibility requirements).

28. *A "quiet" facility*. Finally, could the Fund have a "quiet" facility, under which Fund financing would be provided with little immediate public information? While such a facility would run counter to the general move toward greater transparency in the Fund and among members, it would greatly reduce the stigma problem that might prevent members from approaching the Fund. It would also be analogous to type of lender of last resort transactions that central banks engage in, where the transactions are conducted swiftly and quietly in order to minimize adverse market reaction.

Support specific to low-income members

29. The Fund's low-income members have a wide range of balance of payments and policy support needs which are expected to evolve over time. The Executive Board considered these issues when it discussed "The Role of the Fund in Low-Income Countries."[12]

30. The PRGF framework, with its focus on poverty reduction and growth based on country-owned strategies (PRSs), is still widely used and will remain central to the Fund's engagement with its low-income members. This is especially true for those needing support for longer-term structural reforms or that have not yet reached HIPC completion point. Reforms might be considered to ensure that the PRGF remains valuable to members. These might include potential "re-branding" to reduce any stigma and avoid the implication that the PRGF is only or primarily for countries in need of HIPC debt relief, although it should be noted that for more than half of the 23 HIPC completion point countries new PRGF arrangements have already been approved.

31. At the same time, many low-income members have improved their policies and institutions and they have seen their balance of payments strengthen, and some are gaining access to private capital markets as well benefiting from the emergence of non-traditional

[12] See The Role of the Fund in Low-Income Countries, July 23, 2008.

donors and creditors. In the process, there is likely to be a shift from medium-term financial engagement toward greater emphasis on short-term balance of payment support, policy advice, and signaling. Low-income country needs may come to resemble more closely those of emerging markets.

32. Rapid growth in some countries will eventually lead to their graduation from eligibility for the PRGF Trust's concessional resources. In the meantime, many of these members are looking for instruments better suited to their evolving needs than is provided by the standard PRGF framework. Many would benefit from close engagement to help address more sophisticated policy challenges and also value the Fund's signal on the strength of their macroeconomic policies. The PSI has proven valuable in meeting these needs. For others, including those that have achieved greater integration into international capital markets or that are prone to exogenous shocks, instruments to support short-term stabilization without the PRGF's emphasis on longer-term reforms and PRS requirement could be helpful.

33. As an immediate priority, in response to the global food and commodity price developments, a staff paper "Proposed Reforms to the Exogenous Shocks Facility," is considering modifications to the Exogenous Shocks Facility (ESF) to enhance the Fund's ability to provide rapid assistance in a more flexible fashion, while preserving the objectives of donors to the ESF for resources already contributed.[13] This facility became effective in January 2006 but has not yet been used, in part because of largely favorable global conditions but potentially also because it could be streamlined and better integrated with other instruments.

34. Low-income members also are confronted with short-term balance of payments needs that might be home-grown and hence would not be covered by the ESF. While these members can request a traditional stand-by arrangement, those resources are not on concessional terms. The Fund could establish a low-income stand-by arrangement with PRGF terms via the PRGF Trust to address short-term stabilization needs, including due to domestic challenges that lead to balance of payments needs.

35. Further efforts to assess and improve the framework of support for low-income members include a review of initial experience under the PSI; streamlining documentation requirements for the PRGF and PSI reviews; and further consideration of the Fund's engagement with "fragile states." The Board will be presented with papers on these issues in due course.

Streamlining existing instruments

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[13] To be published on www.imf.org.

36. There may also be scope to streamline existing instruments. Based on current usage the following three instruments would be the prime candidates for elimination or reform:

- The Supplemental Reserve Facility (SRF), created in December 1997 during the Asian crisis as the Fund's financing instrument for capital account crises. It carries high surcharges and short maturity to ensure resources are not used when they are not needed and reflecting the risks. The SRF is designed for cases where quick recovery is expected, but, since Korea, no crisis has fit this V-shaped pattern. The review of charges and maturities will consider aligning surcharges on high access across instruments and, since this would remove one distinguishing feature of the SRF, it will also consider whether the SRF remains useful.

- The Compensatory Financing Facility (CFF), created in 1963 to provide low-conditionality assistance for balance of payments needs caused by temporary and largely exogenous export shortfalls or (added later) excess costs of cereal imports. It was last used in 1999. The CFF is most appropriate for middle-income members, since the resources are nonconcessional, but these countries generally have access to market financing to deal with a temporary shock. Countries with underlying balance of payments problems may not have access to market financing, but these countries could only use the CFF in combination with an arrangement with upper credit tranche conditionality. If the CFF remains unused in the current episode of high food prices, it may be time to eliminate it.

- The Extended Fund Facility (EFF), established in 1974, to provide assistance to members whose balance of payments difficulties are expected to be relatively long-term, including because of limited access to private capital, and because of institutional or economic weaknesses that require structural reform. Nowadays the EFF is rarely used and then typically in a blend with PRGF resources—the last stand-alone EFF was approved in 2002.[14] While in principle the blend could be between PRGF resources and general resources provided through a stand-by arrangement, such a blend would not be ideal because of the differences in phasing and repayment maturities. Accordingly, the EFF might still be a useful instrument for countries as they move through the transition from low-income to emerging market countries.

[14] Blended resources combine financing from the PRGF Trust and the general resources account for low-income member countries with higher income levels or non-concessional financing alternatives. Blending is intended to help conserve scarce PRGF resources.

B. Tailoring Conditionality

37. Globalization and integration place a premium on credible and nimble policymaking that responds quickly to changing circumstances. Conditionality should enable, not hinder, such policymaking. The application of conditionality should already take into account the member's circumstances, but there might be scope—within the Conditionality Guidelines—to tailor it further. Since the purpose of conditionality is to safeguard Fund resources and to ensure proper adjustment to balance of payments problems, there might be scope for less conditionality in some cases where access is low, the shock is exogenous and self-correcting, or the member has high policy credibility. Conversely, conditionality will continue to play a key role where access is high, the shock is self-inflicted or requires policy adjustment, or the member has a need for signaling and to establish policy credibility.

38. The following options and alternative conditionality modalities could be considered:

- Some instruments could rely on selective qualification tests and reviews-only monitoring rather than standard periodic test dates and performance criteria. Such a structure would grant more policy space to the member to achieve certain outcomes, and it would allow program discussions to focus more on the forest than the trees. It could be considered for instruments aimed at members with a strong policy record and no major adjustment needs (as in the case of the RAL). At the same time, this structure would give the Fund greater leeway in judging whether a program is on track toward meeting the broad outcomes, thereby, in effect, strengthening the safeguards to the Fund. The disadvantages include potentially less clarity to the member over the availability of financing, and tougher judgments for the Fund when programs go off track.

- The Fund could also consider providing support in the form of outright purchases rather than under arrangements. Currently, outright purchases are provided only in very limited amounts and only for emergency assistance. In an effort to tailor conditionality better to members' varying circumstances, the Fund could consider providing support in the form of one outright purchase, subject to selective qualification criteria, rather than in tranches subject to ongoing conditionality, to members with a very strong policy track record and a sound policy framework in place. This could allow for a quicker response to foreign exchange liquidity pressures than when a full-blown program has to be negotiated. The primary safeguard to the Fund would be the assessment that, based on past record and current policies, the Fund is confident that the member will adjust policies appropriately.

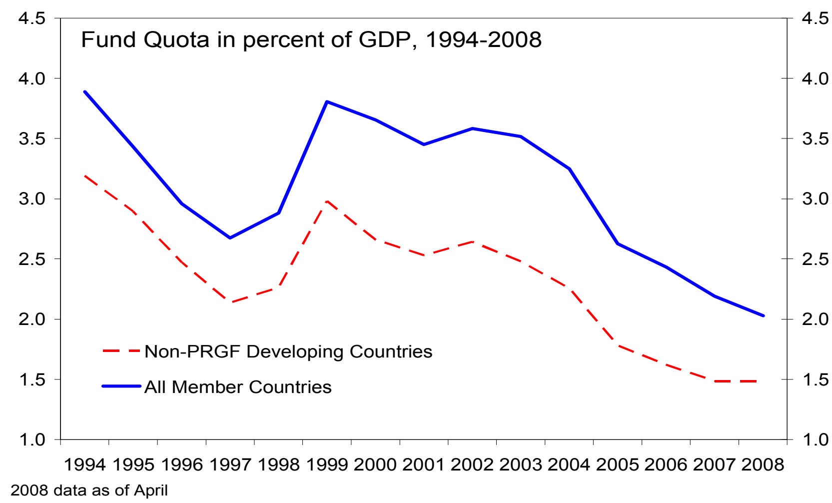
- Finally, the Fund could explore the scope for using collateral (like central banks), which is allowed under the Articles of Agreement but has not been used. Collateral can replace the safeguards role of conditionality. It cannot replace the role of ensuring appropriate adjustment, but as discussed, a growing share of Fund lending is no longer purely for adjustment. A range of complex signaling and implementation issues, including about the type of collateral the Fund could accept, would require careful consideration.

C. Financial Terms: Access Limits and Cost of Fund Credit

39. The size of Fund financial packages and their cost to the member are two important aspects that need to be discussed when considering the Fund's lending role. Papers on these two issues are under preparation, but any proposals will have to take into account possible changes to the Fund's instruments. The main issues for access and surcharges are:

Size of the Fund and Access

40. It is incontrovertible that the relative size of Fund resources is declining. This is true when compared with key indicators for the global economy (world GDP, trade, and capital flows), and it is true for individual members—most of whom have seen their quota shrink relative to their balance of payments flows. At the same time, Fund liquidity has reached very high levels, suggesting that financing constraints are unlikely to be a major limitation to access, except in a systemic crisis. For this reason, no general quota increase was approved in the context of the 13th general review of quotas. But high liquidity could also indicate that the size of Fund lending is too small or conditional to be useful for members' problems, and may be one reason why some member countries are opting for self-insurance.



41. Access by a member to the Fund's resources in the credit tranches and under the EFF is subject to an annual and a cumulative limit, and these limits have remained unchanged since 1994.[15] The access limits serve several purposes, including to ensure that members do not rely

[15] The annual limit is 100 percent of quota and the cumulative limit is 300 percent of quota (net of scheduled repurchases). There are also separate limits of 100 percent of quota annually, and 300 percent of quota cumulatively (net of scheduled repurchases) on overall access by a member to the Fund's general resources.

excessively on Fund financing and to ensure that borrowers are not treated on a "first-come, first-served" basis. Access above these limits can be approved by the Board in exceptional cases, and has been approved on a number of occasions, typically for capital account crises. These decisions on exceptional access involve strengthened due diligence in the form of tests against formal criteria, early Board consultations, and enhanced reporting at the time of the request and after the expiration of the arrangement.

42. Is there a case for raising the access limits? The Board reviewed these access limits in February 2008 and left them unchanged. But since then there have been calls, including in the Spring 2008 IMFC Communiqué, for the Fund to consider raising the limits. The recent quota reform increases the potential borrowing of a number of emerging markets within the access limits, in some cases by a substantial degree, but, given the purposes of the reform, most members received only a small or no increase under the reform. An increase in the limits would have a broader and deeper impact on amounts members can draw, and would send a signal that available Fund financing is being adjusted in tune with members' potential needs. At the same time, access limits have not in practice prevented the Fund from providing high, even exceptional, financing where warranted and the access limits have little direct impact.

43. Access policies under the PRGF were also reviewed and left unchanged in February 2008. They could also be revisited if a broader review of concessional facilities is undertaken.

Cost of Drawing on the Fund's General Resources

44. The cost of receiving financial assistance from the Fund is obviously important for a member's decision to seek Fund support. For the Fund's concessional financing, the structure is simple—a flat 0.5 percent interest rate, subject to availability of subsidy resources. For the general resources the cost structure consists of the following elements:

- A commitment fee on undrawn amounts under an arrangement that is refunded if purchases are made.
- A basic rate of charge on drawn amounts (it is the sum of the SDR rate, which fluctuates, and a Board-approved margin).
- An adjustment for burden sharing added on top of the basic rate.
- A service charge levied on each purchase.
- Surcharges on high access. There is one schedule of surcharges for purchases in the credit tranches or under the EFF, and one for drawings under the SRF. The upcoming review of charges and maturities will consider aligning surcharges on high access across instruments.

The Fund could consider streamlining its fee and surcharge structures. The World Bank recently implemented a significant simplification and reduction in its IBRD loan and guarantee pricing.

45. Determining the "right" cost structure for Fund lending is not straightforward, and the following issues need to be considered. The Fund is not a profit-maximizing institution but a cooperative one created to assist members in balance of payments difficulties, and the cost of its assistance should not be so high as to deter or delay members from seeking assistance when appropriate. And the cost structure should take into account the public good aspects of Fund lending and the Fund's preferred creditor status. At the same time, the Fund should not provide lending that is so cheap that it undermines a member's incentives to borrow from markets or repurchase. Surcharges reinforce the revolving nature of Fund resources in high access cases and help mitigate risks implied in those cases by providing revenue to build precautionary balances (though under the new income model, the margin over the basic rate of charge is also set to allow reserve accumulation). For surcharges, the key questions are whether they should be aligned across Fund instruments, how high they should be, and whether they should increase with the level of access, over time, or both. Implications of the new income model for the adequacy of the Fund's reserves will be discussed in the forthcoming review of precautionary balances and the role and structure of surcharges will be considered in the review of charges and maturities.

VI. Next Steps

46. This paper raises several issues related to how the Fund provides financial assistance to its members. More detailed proposals will be developed later; and indeed the work program already envisages Board consideration of some of the issues raised in this paper.

VII. Issues for Discussion

47. Directors may want to indicate their views on the following broad questions:

- To what extent do Directors think the decline in demand for Fund credit is due to positive global and country-specific developments and to what extent might it also reflect problems with the financing toolkit the Fund offers its members?

- Do Directors see stigma as a problem for the Fund, and if so, what might be considered to reduce it?

- Are the Fund's current lending and signaling instruments adequate for the membership of low-income, middle-income, and advanced countries, and what changes might be made? In particular, what are Directors' views on: (i) a pure signaling instrument for middle-income members; (ii) a crisis prevention instrument, such as the FSL and the RAL; (iii) a short-term liquidity instrument; and (iv) a "quiet" facility. Should the

Fund reconsider whether a balance of payments need should remain the organizing principle for Fund lending?

- Do Directors consider the SRF, CFF and EFF as candidates for elimination?
- Are there are ways to tailor the use of conditionality, to better address the diverse needs of the membership while maintaining adequate safeguards for the Fund and uniformity of treatment? Could there be circumstances where a different model (i.e. not based on conditionality) could be used?
- Are there other areas of reform that should be considered?

Table 1. Use of Fund Credit Among Current Members, 1945-2008 1/

Members that have used Fund credit at least once (150)			Members that have never used Fund credit (35)
Afghanistan	Gambia, The	Nicaragua	Angola
Albania	Georgia	Niger	Antigua and Barbuda
Algeria	Ghana	Nigeria	Austria
Argentina	Greece	Pakistan	Bahamas, The
Armenia	Grenada	Panama	Bahrain
Australia	Guatemala	Papua New Guinea	Bhutan
Azerbaijan	Guinea	Paraguay	Botswana
Bangladesh	Guinea-Bissau	Peru	Brunei Darussalam
Barbados	Guyana	Philippines	Eritrea
Belarus	Haiti	Poland	Germany
Belgium	Honduras	Portugal	Kiribati
Belize	Hungary	Romania	Kuwait
Benin	Iceland	Russian Federation	Libya
Bolivia	India	Rwanda	Luxembourg
Bosnia and Herzegovina	Indonesia	Samoa	Malta
Brazil	Iran	São Tomé and Príncipe	Marshall Islands
Bulgaria	Iraq	Senegal	Micronesia
Burkina Faso	Ireland	Republic of Serbia	Montenegro
Burundi	Israel	St. Kitts and Nevis	Namibia
Cambodia	Italy	St. Lucia	Norway
Cameroon	Jamaica	St. Vincent and the Grenadines	Oman
Canada	Japan	Sierra Leone	Palau
Cape Verde	Jordan	Slovak Republic	Qatar
Central African Republic	Kazakhstan	Slovenia	San Marino
Chad	Kenya	Solomon Islands	Saudi Arabia
Chile	Korea	Somalia	Seychelles
China	Kyrgyz Republic	South Africa	Singapore
Colombia	Lao P.D.R	Spain	Suriname
Comoros	Latvia	Sri Lanka	Sweden
Congo, Democratic Republic	Lebanon	Sudan	Switzerland
Congo, Republic	Lesotho	Swaziland	Timor-Leste
Costa Rica	Liberia	Syrian Arab Republic	Tonga
Côte d'Ivoire	Lithuania	Tajikistan	Turkmenistan
Croatia	Macedonia, F.Y.R.	Tanzania	United Arab Emirates
Cyprus	Madagascar	Thailand	Vanuatu
Czech Republic	Malawi	Togo	
Denmark	Malaysia	Trinidad and Tobago	
Djibouti	Maldives	Tunisia	
Dominica	Mali	Turkey	
Dominican Republic	Mauritania	Uganda	
Ecuador	Mauritius	Ukraine	
Egypt	Mexico	United Kingdom	
El Salvador	Moldova	United States	
Equatorial Guinea	Mongolia	Uruguay	
Estonia	Morocco	Uzbekistan	
Ethiopia	Mozambique	Venezuela	
Fiji	Myanmar	Vietnam	
Finland	Nepal	Yemen	
France	Netherlands	Zambia	
Gabon	New Zealand	Zimbabwe	

Source: International Monetary Fund.

1/ As of April 2008.

Table 2. Fund Facilities and Instruments 1/

Name	Purpose	Access limits	Phasing and monitoring	Terms: Charges and fees: Charges	Terms: Charges and fees: Surcharges	Terms: Charges and fees: Other	Terms: Repayment terms: Obligations schedule (years)	Terms: Repayment terms: Expectations schedule (years)
General Resources Facilities and Policies								
Stand-By arrangement (1952)	For all types of balance of payments need (including precautionary) of short-term character.	Annual: 100% of quota. Cumulative: 300% of quota. Limits can be exceeded in exceptional circumstances.	Quarterly purchases contingent on observance of performance criteria and other conditions.	Basic rate of charge	Level-based: 100 basis points on outstanding access above 200 percent of quota, and 200 bps on access above 300 percent of quota.	Commitment fee and service fee 2/	3 1/4-5	2 1/4-4
Extended Fund Facility (1974)	For balance of payments need of a longer-term character for members with limited access to capital markets.	Same as above.	Quarterly or semi-annual purchases contingent on observance of performance criteria and other conditions.	Basic rate of charge	Same as above.	Commitment fee and service fee 2/	4 1/2-10	4 1/4-7
Supplemental Reserve Facility (1997)	For exceptional, short-term balance of payments (capital account) need resulting from a sudden and disruptive loss of market confidence.	No limits. SRF used only when access under associated stand-by or extended arrangement would be exceptional.	Front-loaded access with two or more purchases.	Basic rate of charge	Time-based: From the date of the 1st purchase the surcharge is 300 bps and rises by 50 bps at the end of the first year and every six months, up to a maximum of 500 bps.	Commitment fee and service fee 2/	2 1/2-3	2-2 1/2
Compensatory Financing Facility (1963)	For balance of payments need related to temporary export shortfalls or cereal import excesses that is largely beyond the member's control.	45% of quota each for export and cereal components; combined limit of 55% of quota.	Typically available over a minimum of six months. Can be outright purchases, or together with an arrangement.	Basic rate of charge	None	Commitment fee and service fee 2/	3 1/4-5	2 1/4-4
PRGF (concessional) Resources Facilities-for low-income, PRGF-eligible members								
Poverty Reduction and Growth Facility (1999)	For deep-seated balance of payments need of structural nature; aims at sustained poverty-reducing growth.	140% of quota; 185% in exceptional circumstances.	Semi-annual (or occasionally quarterly) disbursements contingent on observance of performance criteria and other conditions.	0.50%	None	None	5 1/2-10	None
Exogenous Shocks Facility (2006)	For temporary balance of payments need due to exogenous shocks.	Annual: 25% of quota. Cumulative: 50% of quota. Limits can be exceeded in exceptional circumstances.	Semi-annual or quarterly disbursements contingent on observance of performance criteria and other conditions.	0.50%	None	None	5 1/2-10	None
Emergency Assistance								
Emergency Natural Disaster Assistance (1962)	For balance of payment need related to natural disasters.	25% of quota. Limit can be exceeded in exceptional circumstances.	None	Basic rate of charge 3/	None	None	3 1/4-5	None
Emergency Post-Conflict Assistance (1995)	For balance of payment need related to the aftermath of civil unrest, political turmoil, or international armed conflict.	Annual: 25% of quota. Cumulative: 50% of quota over 3 years. Limits can be exceeded in exceptional circumstances.	None, but can be segmented into two or more purchases.	Basic rate of charge 3/	None	None	3 1/4-5	None
Other Instruments								
Policy Support Instrument (2005)	For PRGF-eligible members that are so called mature stabilizers. No balance of payments need, but seek Fund advice, monitoring, and support of their economic policies.	N/A	Quantitative assessment criteria, normally set semi-annually, with reviews conducted irrespective of the status of the program.	N/A	N/A	N/A	N/A	N/A
Trade Integration Mechanism (2004)	Policy designed to increase the predictability of resource availability under existing members with balance of payments shortfalls due to trade liberalization measures undertaken by other countries.	10% of quota.	Terms and phasing would be determined by the underlying facility (SBA, EFF, or PRGF) from which access is provided.					

1/ As of May 31, 2008.
2/ The commitment fee is 25 basis points on access up to 100 percent of quota; 10 bps on access above that level. The service fee of 50 bps on each purchase.
3/ For PRGF-eligible members, the interest rate on loans can be subsidized down to 0.5 percent per year, with the interest subsidies financed by grant contributions from bilateral donors.