INTERNATIONAL MONETARY FUND

Strengthening the Fund's Ability to Assist Low-Income Countries Meet Balance of Payments Needs Arising from Sudden and Exogenous Shocks -- Supplement

Prepared by the Policy Development and Review Department

(In consultation with other departments)

Approved by Mark Allen

July 22, 2005

1. The G-8 debt relief proposal, if adopted, should have little impact on the rationale and operational aspects of the shocks window, but it may affect some of the financing considerations, which are taken up in the paper on *The G-8 Debt Cancellation Proposal and its Implications for the Fund.*

2. Even after full implementation of further debt relief, the rationale of assisting low-income countries in responding to adverse exogenous shocks remains valid, particularly given the continuing vulnerability of these countries to such shocks and the focus on achievement of the Millennium Development Goals. Typically, the appropriate response to a shock involves a mix of policy adjustment and financing, and the proposed shocks window would be able to provide the relevant support. The proposed window also remains appropriate to the needs of low-income countries because it is more concessional than current alternatives (mainly stand-by arrangements in the credit tranches and emergency natural disaster assistance) and is likely to be quicker-disbursing than available grant mechanisms. More broadly, the link between financing and conditionality under the facility remains an important mechanism for safeguarding resources and may also provide a useful signal for donors that post-shock cases have adopted an adequate mix of adjustment and financing.

3. The proposed operational guidelines for the shocks window would also remain valid even after further debt relief. The proposed access norms are consistent with the record of PRGF augmentations (the primary means of support when a shock occurs during a PRGF arrangement), the catalytic role of Fund financing, and access under the policy on emergency assistance for natural disasters. Conditionality under the shocks window should continue to focus on adjustment to the shock, as initially proposed.

Issues of demand for and financing of the shocks window are not addressed in this paper. However, in broad terms, the need for shocks financing is unlikely to change dramatically after adoption of the debt relief proposal. The frequency and size of shocks will not change. A variety of potential channels of influence exist. For example, the proposed debt relief could reduce demand for the shock window if countries self-insure against shocks through increased reserve accumulation as a result of further debt relief. However, such selfinsurance is unlikely to happen other than in the short run as the debt relief is expected to be spent for achieving the MDGs. Overall, it is expected that the effects of further debt relief on demand are likely to be small. The financing may be affected by the availability of PRGF Trust resources; this issue is taken up in *The G-8 Debt Cancellation Proposal and its Implications for the Fund*.

5. One issue that may usefully be noted here is that further debt relief and associated implications for PRGF operations may have implications for the relative importance of the shocks window per se and PRGF augmentations in overall shocks financing. PRGF augmentations are expected to remain the primary vehicle for shocks-related financing for countries with standard PRGF arrangements. Further debt relief may enable recipient countries to reduce demand for PRGF arrangements and increase that for the Policy Support Instrument. This would imply that a larger proportion of shocks-related financing would be covered by the proposed new window rather than PRGF augmentations.