INTERNATIONAL MONETARY FUND

Establishment of an Exogenous Shocks Facility Under the Poverty Reduction and Growth Facility Trust

Prepared by the Policy Development and Review and Finance Departments

(In consultation with other departments)

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I. Introduction[1]

1. **At the recent Board discussion on strengthening the Fund's assistance to low-income countries dealing with sudden and exogenous shocks, most Directors supported the establishment of an Exogenous Shocks Facility (ESF) within the Poverty Reduction and Growth Facility (PRGF) Trust.[2]** In an earlier discussion, Directors noted that exogenous shocks could have significant negative impacts on developing countries' growth, macroeconomic stability, debt sustainability, and poverty, and that low-income countries are particularly vulnerable to shocks due to lack of diversification, limited capacity to build up reserves, and prohibitively expensive or unavailable market insurance.[3] The international community can supplement national efforts for reducing vulnerability to shocks. Recent research shows that foreign assistance can be unusually effective in the aftermath of a shock. Such assistance needs to be available quickly, and it needs to be associated with sound adjustment policies and measures to reduce vulnerability to future shocks. In this context, establishing a new facility in the PRGF Trust will complement existing Fund instruments for providing timely concessional support to low-income members.

2. **The modalities discussed below on the establishment of the ESF are based, in part, on the guidance received from Executive Directors.** Most Directors supported staff proposals on a number of features of the new facility, and the basic structure is summarized in the next section. Staff has also formulated more specific proposals on a number of issues raised in general terms during the previous Board discussion, including (i) definition of qualifying events; (ii) other operational modalities; (iii) relationship with other facilities; and (iv) relationship with the PRS process. These issues are discussed in Section III. The estimated demand for shocks financing is discussed in Section IV, options for financial arrangements are presented in Section V, and issues for discussion are presented in Section VI.

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[1] This paper was prepared by Jianhai Lin and Robert Price (FIN) and Andrew Berg, Carlos Leite, and Mumtaz Hussain (PDR). Ms. Weeks-Brown (LEG) provided extensive drafting suggestions.

[2] *Strengthening the Fund's Ability to Assist Low-Income Countries Meet Balance of Payments Needs Arising from Sudden and Exogenous Shocks*.

[3] *Role of the Fund in Low-Income Member Countries Over the Medium Term*, *Fund Assistance for Countries Facing Exogenous Shocks* and (PIN No. 03/117, September 10, 2003).

II. Basic Structure of the Exogenous Shocks Facility

3. **The ESF is designed to provide concessional financing to PRGF-eligible member countries that are experiencing sudden and exogenous shocks but do not have a PRGF arrangement in place.**[4] The interest rate and repayment terms for the new facility would be the same as those of the PRGF. Directors expressed broad support for setting the length of arrangements under the ESF at 1-2 years, shorter than those under the PRGF. Given that these arrangements are shorter and that shocks are the primary source of the balance of payments need, Directors recognized that members' programs could be less ambitious in terms of structural reform than under a PRGF arrangement. Nevertheless, structural issues considered important for adjustment to the shock, or for mitigating the impact of future shocks, should be properly addressed in an arrangement under the ESF. Conditionality in programs supported by the ESF would meet the same standard, and fulfill the same functions, as in an upper credit tranche (UCT) arrangement.

4. **Qualification under the ESF would be based upon a determination that the shock is the primary source of an actual balance of payments need.** In contrast to the Compensatory Financing Facility (CFF) where the source of the balance of payments need and financing in response to a shock is assessed mechanically, the extent of the balance of payments need resulting from a shock would be determined judgmentally, taking into account the relevant factors in each case.

5. **Most Directors supported the view that the norm for annual access under the ESF would be 25 percent of quota,** but access will be determined on a case-by-case basis, taking into account factors similar to those used in assessing PRGF access. In particular, in judging the mix of adjustment and financing and access, consideration would be given to the size and likely persistence of shocks, projected response from donors, policy performance of the affected country, and previous use of Fund resources. This access norm is higher than the average of past augmentations of PRGF arrangements but broadly consistent with the rules for access to Emergency Natural Disaster Assistance (ENDA) and the CFF. For low-income members subject to a blending of concessional and non-concessional financing, the annual access norm will be 12½ percent of quota under the ESF. Given the scarcity of concessional resources, total outstanding balances from this facility would be subject to an access limit of 50 percent of quota barring exceptional circumstances.[5]

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[4] For those countries with a PRGF arrangement in place, Directors agreed that the best response for assisting members facing shocks will continue to be an augmentation of the resources available under that arrangement. Directors concurred that an existing PRGF arrangement provides a suitable framework for determining the policy response to the shock, including measures to protect the most vulnerable sections of society.

[5] Unlike the case with the PRGF, no maximum limit would be specified for ESF exceptional access. It is expected, however, that cases involving access above the 50 percent limit would be rare, and the degree of divergence limited.

6. **An on-track Policy Support Instrument (PSI), with the associated upper credit tranche conditionality, would facilitate access under the ESF** because it would reduce the time normally required to design an appropriate program and demonstrate that it can be implemented successfully. There would be no automatic link between a PSI and access to financing under the ESF. However, access would be facilitated insofar as adjustments to the program endorsed and assessed under a PSI would be limited to those needed to correct the balance of payments need arising from the shock. Similarly, access to Fund resources, including under the ESF, would be facilitated for PSI users that choose to undertake a safeguards assessment; quick access may not be possible for PSI users that choose not to undertake such an assessment. For members without an on-track PSI, reaching understandings on a program to be supported by the ESF could take somewhat longer, as it would require appropriate elaboration.

III. Staff Proposals for Modalities

A. Qualifying Events

7. **The ESF framework allows scope for judgment with respect to the nature of the shock and the link between the shock and the balance of payments need.** There is, therefore, unlike in the CFF, neither a specific set of qualifying shocks nor a formulaic method for associating balance of payments need with a particular shock.

8. **For purposes of this facility, an exogenous shock is defined as an event beyond the control of the authorities of the member, with a significant negative impact on the economy. In view of these considerations, qualifying exogenous events could include terms-of-trade shocks, natural disasters, shocks to demand for exports, or conflict or crisis in neighboring countries that has adverse balance of payments effects.** Conversely, shocks resulting from the variability of aid flows or from domestic financial crises would not be included, given the difficulty in determining whether they are endogenous or exogenous in nature.[6] Balance of payments needs resulting predominantly from domestic policy slippages would not qualify for the ESF. The qualifying shock should be the primary source of an actual balance of payments need and it should be sudden.[7]

9. **The facility is designed to provide temporary balance of payments support to an appropriate adjustment program.** It is not a requirement that the shock itself be judged temporary, but that the resulting balance of payments need be temporary. The period for an ESF arrangement will range from one to two years. The program should include appropriate

[6] In addition, the Fund would not be able to play a catalytic role in the case of aid shortfalls.

[7] Whether a particular shock is "sudden" will need to be assessed judgmentally by staff and the Board, taking into account all relevant factors. Commodity price changes that take place over a few months, such as the recent increase in oil prices, should qualify as sudden; gradual declines that only create significant balance of payments problems when they persist over a period of years would not.

adjustment given the likely degree of persistence of the shock and could be revised as the situation unfolds. In those cases where the balance of payments need associated with the shock persists, and a subsequent assessment indicates the need to formulate a longer-term program designed to address a protracted problem, a PRGF arrangement would become the appropriate vehicle. Members could not avail themselves of multiple arrangements under the ESF for the same shock.[8]

10. **There are clear distinctions between the ESF and the PRGF.** As a condition for approval of an ESF arrangement, a sudden and exogenous shock must have occurred and it must be the primary source of an actual balance of payments need;[9] in addition, a representation of a balance of payments need as defined in the context of the GRA would be a condition for each ESF disbursement.[10] The PRGF, on the other hand, is appropriate where there is a protracted balance of payments problem requiring both policy adjustment and structural reforms aimed at achieving macroeconomic stability; no representation of balance of payments need is required for PRGF disbursements.[11] ESF financing would normally be available to those low-income members that do not need to implement broad structural reforms in order to allow successful adjustment to the shock. This would suggest that ESF financing would not be appropriate, for example, in most cases where a PRGF arrangement was off track before the shock. In these cases, a PRGF arrangement would be more appropriate.[12] In addition, and as noted above, where a shock turns out to create a more persistent need than originally anticipated and more extensive adjustment measures and structural reforms are necessary, the member country would be expected to consider a subsequent arrangement under the PRGF.

11. **The ESF is also distinct from Emergency Assistance, notwithstanding some degree of overlap**. ESF financing is more concessional than Emergency Post-Conflict Assistance (EPCA) and ENDA. However, EPCA is normally appropriate for assistance to post-conflict countries, given likely capacity constraints in preparing and implementing a

[8] If the same sort of shock repeats itself, as with a commodity price that increases sharply then, a few years later, increases again, subsequent episodes could qualify under the ESF.

[9] Thus, there could be no precautionary ESF.

[10] The balance of payments need for these purposes would be the same as in the context of Article V of the Articles of Agreement, and thus would take into account the member's balance of payments and reserves position, as well as development in its reserves.

[11] If an existing PRGF arrangement is in place when the shock occurs, augmentation and policy adjustment would be the appropriate response, rather than ESF access.

[12] The fact that a member might be discussing the possibility of a PRGF arrangement at the time of the shock would not in itself disqualify the member from access under the ESF but would raise the question of whether the underlying policies are indeed strong enough to support appropriate adjustment.

comprehensive program that meets upper credit tranche conditionality. ENDA is normally appropriate for assistance in the aftermath of natural disasters where the member is unable to formulate and implement a comprehensive program immediately. However, if policy adjustment is essential to restoring a sustainable balance of payments position, then the ESF would be more appropriate.

B. Other Operational Modalities

12. As outlined in the previous paper on the shocks facility, the member and Fund staff would conduct discussions on a program of economic and financial policies following an expression of interest in an arrangement under the ESF. The Managing Director would recommend Executive Board approval of a request for an ESF arrangement, provided the members' policies, as described in the Letter of Intent (LOI) or memorandum of economic and financial policies (MEFP), met the standard applicable to policies under a UCT arrangement.

Phasing of performance criteria and disbursements

13. **Disbursements could be phased at semi-annual intervals, as customary in PRGF arrangements or at quarterly intervals, as customary with SBAs.** Appropriate phasing would depend on the arrangement's duration, the balance of payments need, the volatility of the economic situation, and capacity constraints on the part of the authorities.[13] The first disbursement will be made available upon approval of the arrangement, and subsequent disbursements will be contingent on observance of performance criteria, and in most cases, completion of a review.[14]

14. **Since immediate assistance can be important in minimizing the disruptive effect of shocks, phasing of disbursements under the ESF may be front-loaded.** An early response to a shock helps contain and minimize the negative impact on the country's future growth path, and the ESF allows the Fund to play a key role in the assessment of the appropriate mix of adjustment and financing in response to a shock. Although grant financing would be preferable in terms of implications for debt sustainability and repayment burdens, Fund financing may play an important role in the early stages of response to a shock, including by providing donors with a clear signal on the strength of the authorities' own

[13] It may be, for example, that with the member country's technical capacity strained by the effects of the shock, less frequent assessment missions by IMF staff may allow policymakers to focus on implementation issues.

[14] In any case, as a general rule, the date of the second disbursement would not be earlier than two months from the initial disbursement on approval of the arrangement, and the date of the last disbursement would not be earlier than two months before the end of the arrangement (Decision No. 7925-(85/38), adopted March 8, 1985).

response. In addition, staff may consider frontloading disbursements if the availability of other resources is expected to be delayed.

Other Fund guidelines and policies

15. **The decision establishing the ESF would generally make applicable to the ESF all Fund decisions and instruments pertaining to the PRGF.** In addition, as a use of Fund resources (UFR) facility under the same Trust, the ESF would generally be subject to the same modalities and rules as apply to the PRGF, except in the areas where a special ESF modality is proposed (e.g., with respect to PRS process and length of arrangements). Thus, for example, the Guidelines on Conditionality would apply to the ESF; publication of the member's LOI/MEFP, staff report and other ESF-related documents would be subject to the same publication rules as PRGF-related documents; the PRGF guidelines on misreporting would be applicable; and side letters may be used. Similarly, the safeguards assessments framework would be applicable; disbursements under the ESF would count towards the thresholds for Post-Program Monitoring; and an ESF arrangement would also count towards the determination of longer-term program engagement and towards the two-year Article IV consultation cycle for members with Fund-supported programs. The Fund's policies on financing assurances and obligations to external creditors would also apply, including on lending into arrears. Collaboration with the World Bank will follow established practices that apply in the context of PRGF arrangements.

16. Because an arrangement under the ESF would be a UFR arrangement meeting UCT conditionality, **performance under ESF arrangements would in principle count towards a track record of policy implementation for purposes of reaching the decision point and completion point under the enhanced HIPC Initiative.**

C. Relationship to the PRS Process

17. **Use of the ESF would normally require that a poverty reduction strategy as evidenced by a PRS document (i.e., I-PRSP, PRSP preparation status report, PRSP, or Annual Progress Report) be in place at the time of approval of the arrangement or, in exceptional circumstances, by the time of the first review.** The Fund, along with the World Bank and many other development agencies, is committed to using the PRSP as the operational framework for its support to low-income countries under the PRGF, and to aligning the content and process of its operations to reflect this framework. Approximately 70 percent of PRGF-eligible members have prepared either an I-PRSP or a full PRSP, and the majority of the remaining countries have a PRS process underway. Where an existing PRSP has adequate contingency plans for shocks, these plans should form the basis of the economic program under the ESF.[15]

[15] Even in the absence of such contingencies, the design of the program supported by the ESF should give due consideration to the need to protect the poor, often those most adversely affected by shocks.

18. Given the need for an immediate response to the underlying shock, **access to concessional assistance, where appropriate, should not be delayed if no poverty reduction strategy is in place as evidenced by the issuance of a PRS document to the Executive Board within the previous 18 months**. Accordingly, in those exceptional cases where the preparation of a PRS document would unduly delay approval of an ESF arrangement, issuance of the PRS document to the Executive Board should be a condition for the first review, provided that, at the time of approval of the arrangement, the Board is assured of the government's commitment regarding its poverty reduction strategy during the period of the arrangement. In most of the cases where issuance of an I-PRSP is necessary, the member should be in a position to prepare the document based on existing policies—such as a macroeconomic framework, previous poverty assessments, and current development strategies.[16] The PRS document would normally be accompanied by a Joint Staff Assessment Note (JSAN), which may identify some deficiencies of the member's poverty reduction strategy. Unlike with the PRGF, however, the extent to which these deficiencies would need to be addressed prior to approval of the arrangement or completion of a review would be assessed on a case-specific basis.

IV. Estimated Demand for Shocks Financing

19. To determine loan and subsidy resource costs for the new shocks facility requires an estimate of expected demand for total low-income shocks financing from the Fund. **Staff projects a total demand of SDR 400 million per year on average over the medium term,** based on a staff survey of likely demand for total shocks financing.[17] Staff projections were guided by historical data on frequency of two types of shocks—terms-of-trade shocks and natural disasters—and on use of Fund resources, as well as the characteristics of the new shocks facility. This exercise (and thus the figure above) estimated total demand for shocks financing by low-income members and thus did not differentiate between demand for PRGF augmentations arising from shocks and demand for financing under the ESF.[18]

[16] *Poverty Reduction Strategy Papers—Operational Issues*. The preparation of an I-PRSP is not intended to be an onerous process, and the guidelines envision situations where the content is limited to "a government statement expressing commitment to reducing poverty, to an outline of the nature of the poverty problem and of government strategies to tackle the problem, and to a timeline and process for preparing a PRSP together with a matrix and macroeconomic framework" (*op. cit.*, p. 21).

[17] The potential average annual demand would be considerably higher if a few countries with the largest quotas were to request access at higher-than-expected rates under the ESF.

[18] Of the SDR 400 million in total annual demand for shocks financing, some SDR 250 million is expected to be associated with the ESF and SDR 150 million with PRGF augmentations; this breakdown is highly sensitive to assumptions about the relative frequency of PSI and PRGF arrangements over the medium term.

20. This estimated future demand is somewhat higher than past use of Fund resources to deal with shocks. **The future use of shocks financing from the Fund is expected to be higher than historical patterns would suggest**, for several reasons:

- increasing awareness of the adverse impacts of shocks on growth and poverty reduction, which is likely to result in more proactive support from the international community (including the Fund) to low-income countries;

- establishment of the ESF, which will provide more concessional financing than the CFF and ENDA and would have access norms larger than the historical access level for PRGF augmentation; and

- recent guidelines on PRGF augmentation, which are likely to encourage countries to request more financing following a shock and help staff assess needs (and appropriate access levels) on a more systematic basis.

21. **The ESF addresses only part of the demand for shocks financing, because it is designed for PRGF-eligible member countries that do not have a PRGF arrangement in place.** For those countries with a PRGF arrangement in place, needed financing will continue to be provided through augmentation of the PRGF arrangement. While recognizing that there is inherently considerable uncertainty about future demand as well as mix of use of Fund resources under the ESF and PRGF augmentation, staff is of the view that it would be prudent for the Fund to be prepared to provide total concessional shocks financing at SDR 400 million per year over the medium term.

V. Financing Arrangements

22. **The ESF is a new facility which will require additional loan and subsidy resources.** Loan resources would be sought from bilateral creditors and secured by the PRGF Reserve Account, as at present. As regards subsidy resources, a separate trust could be established. Both loan and subsidy resources will need to be secured before the facility can be made operational. In order to ensure an on-going capacity to assist low-income countries under the ESF, the Fund should aim at securing sufficient resources to cover financing needs of the facility for the next decade. Demand for shocks-related PRGF augmentations also needs to be taken into account, since as noted above members with an existing PRGF arrangement that are hit by a qualifying shock would be expected to request an augmentation of that arrangement rather than access under the ESF. Taking into account the projected demand for shock financing under both the ESF and PRGF augmentations, this implies that, based on the projected demand for shock financing discussed above, the Fund would need to mobilize new loan resources of SDR 4 billion (for the Loan Account of the PRGF Trust) and subsidy resources of about SDR 1 billion (under the possible new trust) for this period.[19]

[19] The projected subsidy resources would cover subsidies for the lifetime of the loans before they are repaid.

23. **Firm up-front commitments would be required to launch the new facility. In staff's view,** the launch of the ESF should be considered once commitments for resources sufficient to cover the projected total needs for ESF and PRGF shock financing over the next five years have been secured. This initial target would strike a balance between the need for sufficient up-front commitments to ensure that the ESF will be available over the medium term and the need for an early start of the facility. This suggests that the Fund would need to have firm commitments on total shocks-related loan and subsidy resources of SDR 2 billion and SDR 0.5 billion, respectively, before launching the ESF.

24. **The next step would be for staff to consult with donors about possible contributions to the ESF on the basis of the Board's discussion of this paper.** Once these discussions had reached an appropriate stage, the Board would need to adopt decisions, inter alia, amending the purposes of the PRGF Trust to include the ESF. This would require an 85 percent majority of the total voting power and consent of all 44 creditors and contributors to the PRGF Trust Loan and Subsidy Accounts. The new trust for shocks subsidy purposes could be established by a decision adopted by a majority of the votes cast. If desired by donors, the trust could provide for separate subaccounts, into which resources could be earmarked for ESF subsidies only, or for both ESF and PRGF augmentation-related subsidies.

VI. Issues For Discussion

25. The paper summarizes the basic structure of the proposed Exogenous Shocks Facility, outlines specific proposals on modalities, and discusses financial requirements and options for financial arrangements. Do Directors agree that:

- the facility should be structured as suggested in Section II and III above?
- the Fund should establish a new trust for the purpose of securing the subsidy resources needed for total concessional lending in support of low-income members facing exogenous shocks?
- staff's estimate of SDR 2.0 billion in new loan resources and SDR 0.5 billion in new subsidy resources, which would enable lending for the first five years under the ESF, and for PRGF shocks-related augmentations, are reasonable initial targets for such contributions?
- firm financing commitments should be obtained before the ESF becomes operational?