Web Document 5.H: Currency Stabilization Funds

On September 13, 1995, the Executive Board established a policy on the use of Fund resources to finance currency stabilization funds (CSFs). This policy was set forth in the summing up of the discussion at EBM/95/86 and in an attachment with specific guidelines for CSF support.

... Directors in their majority have supported the conditions and operational characteristics outlined in the statement by the staff. However, some Directors continued to express doubt about the need for a special policy in this area, and some have mentioned areas of concern. Some of you indicated a preference for a special facility, but some of those were prepared to support a consensus on the window approach. Among the main concerns raised today were the fear that establishment of a CSF would appear to signal a Fund preference for a fixed exchange rate, the possibility of too frequent use of the exceptional circumstances clause and the importance of ensuring that use of the exceptional circumstances clause would be very rare, the inherent difficulty of assessing the appropriate level of the exchange rate to be supported by a CSF, the timing and circumstances of possible adjustments to the exchange rate arrangement, and the need to provide for adequate safeguards and suitable procedures, including close involvement of the Board at all stages.

With respect to the framework for CSF operations, all Directors stressed the importance of the country's having a sound track record, of keeping the exchange arrangements under continuous review both during and after the disinflation effort, and of ensuring that CSF resources were used as intended—that is, to provide a temporary supplement to reserves for confidence building and short-term intervention if needed, and not for general balance of payments support. In this connection, Directors attached importance to the frequent reporting of relevant data, and close monitoring by the staff and the Board, as well as the tranching and repurchase/reconstitution provisions.

Although the sense of the Board is clearly that we should move cautiously in this area, it has been broadly agreed that under certain conditions the Fund should be prepared to support CSFs within the context of upper credit tranche stand-by or extended arrangements. The conditions and modalities outlined in the statement by the staff provide an appropriate framework for this purpose. Accordingly, the amended text of that statement, which is attached to this summing up will provide guidelines for the use of Fund resources under a CSF. Executive Directors do not expect that there will be frequent recourse to CSFs, nor would the Board wish, by establishing CSFs, to signal any preference on the part of the Fund for fixed exchange rates or exchange rate based stabilization. The staff will discuss alternative approaches and forms of Fund support with members and, where a CSF is recommended, will clearly explain the rationale for the approach that is being followed in the documentation for the Board. Where a CSF is being considered and at an appropriate point, recognizing the particular sensitivities of this kind of situation, management will consult with the Board. It is understood that any such operations will be approached in an experimental fashion, kept under close review in light of Directors' concerns and, if necessary, adapted on the basis of experience.

Attachment. Guidelines for Fund Support for Currency Stabilization Funds

1. General considerations

a. Framework and purpose

Experience has shown that under certain circumstances a nominal exchange rate anchor can be a powerful instrument, when employed in the context of strong macroeconomic stabilization policies, in bringing about a rapid decline in inflation. In the framework of a Fund upper credit tranche stand-by or extended arrangement, Fund financial support for the specific purpose of providing a precautionary pool of resources to supplement reserves for a transitional period—that is, a currency stabilization fund (CSF)—could provide an important element of additional confidence in support of an exchange-rate-based stabilization strategy and, under appropriate conditions, would be consistent with the purposes of the Fund.

In particular, for CSFs to play their intended role, economic policies would need to be sufficiently tight to deliver an inflation path compatible with the targeted exchange rate anchor—that is, the anchor would need to be realistic and sustainable on the basis of the member's policies, so that little, if any, use of the CSF for exchange market intervention would be expected; it would need to be understood with the authorities that economic policies would be adapted promptly as necessary in response to changing conditions, so as to ensure the maintenance of the nominal exchange rate objective; and the underlying program would need to be fully financed (i.e., without taking account of the resources of the CSF).

b. Adjustment strategy

Fund support for CSFs would be considered in cases of high inflation where a nominal exchange rate anchor is adopted as part of a credible, comprehensive adjustment strategy to achieve a rapid and substantial decline in inflation and where close monitoring is possible to ensure that the exchange rate anchor and supporting policies continue to be appropriate. It would be expected that a CSF would be activated at a relatively early stage in the process of reducing inflation, but only when the Fund can be confident that the member's policies are sufficiently strong and will be implemented and adapted as necessary; activation could take place at the outset of an arrangement or during the course of a review.

c. Exchange rate arrangement

The most appropriate exchange rate arrangement to be supported by a CSF would be an exchange rate peg with relatively narrow margins, or a preannounced crawl, that would limit the discretionary use of the exchange rate. Careful consideration would need to be given to establishing the appropriate level at which to establish the exchange rate peg (or crawl), avoiding a real exchange rate that is excessively low or high relative to historical levels or other relevant indicators. It would not be the purpose to maintain the anchor indefinitely, and the appropriateness of the exchange rate and the exchange arrangement would be kept under continuous review by the authorities and the Fund, both during and subsequent to the disinflation effort.

d. Policy conditions

The policy conditions necessary to ensure the success of an exchange-rate-based stabilization, and thus essential to Fund support for a CSF, include: 1) fiscal adjustment and credit creation consistent with targeted inflation; 2) appropriate measures to deal with backward-looking automatic wage and other indexation schemes; 3) establishment of a high degree of current account convertibility and an open trade regime, and other measures to encourage a return of flight capital; 4) contingency plans for dealing with large capital outflows or inflows, which would depend on full interest rate flexibility and should also involve contingency fiscal measures; 5) establishment of integrated operational management of foreign exchange reserves and intervention policy; and 6) other structural and institutional elements supportive of the effort to reduce inflation sharply. More specific conditions would depend on the particular circumstances of each country.

e. Co-financing

It would be possible to consider co-financing of CSFs; however, certain basic principles would need to govern Fund policies with regard to co-financing for Fund-supported CSFs. First, the Executive Board would retain control over all use of Fund resources in support of CSFs. Second, co-financing should not unduly complicate the operations of CSFs. Third, terms associated with resources provided through co-financing should be at least as favorable to the borrower as those associated with Fund financing. Fourth, resources made available through co-financing procedures should not in any way affect the safeguards of Fund resources and the Fund's preferred creditor status. If co-financing were judged to be feasible and beneficial in a particular case, specific features would need to be determined at that stage.

2. Operational characteristics

a. Structure

A CSF would be established as an element (or "window") within a Fund upper credit tranche stand-by or extended arrangement and would have revolving features permitting repeated use under specified conditions. ESAF-eligible member countries would be able to use CSFs through arrangements in the General Resources Account that would operate in parallel to an ESAF arrangement.

b. Access

Access under arrangements including a CSF element would be subject to the limits (annual and cumulative) applicable to stand-by and extended arrangements. Maximum access under the CSF element would be 100 percent of quota; this would be a sublimit within the access policy. Access under the CSF element would be determined on a "net" basis—that is, outstanding use of CSF resources could not exceed a specified percentage of a member's quota (not exceeding 100 percent in any case), taking account of the repurchase and reconstitution procedures set out below. The determination of access levels for individual cases would be guided by the usual criteria of need, strength of policies, and capacity to repay the Fund, taking into account the adequacy of precautionary reserves to instill confidence in the member's exchange rate regime. In practice, access under CSFs would be expected to vary considerably on a case-by-case basis, depending on the degree to which the assessed need for reserves was already met from other sources.

c. Tranching

Normally, a CSF would have four equal tranches, with flexibility to raise access under the first tranche to a maximum of 35 percent of the size of the CSF with offsetting reductions in the third and fourth tranches (i.e., 25/25/25/25 percent or 35/25/20/20 percent of the size of the CSF or other variations in between) depending on the particular circumstances of each case. There would also be flexibility, where warranted by the circumstances, to vary the number (and consequently the size) of tranches within a range of three to five tranches.

d. Reporting requirements

The documentation establishing a CSF would specify the precise details of the reporting requirements. These would need to be sufficient to enable the Board to assess the appropriateness of requests for activation, availability of resources and extensions of repurchase expectations under a CSF. Daily reporting of key financial variables (such as exchange rates, interest rates, exchange market turnover, intervention, and reserves) would be expected. Reporting requirements could be modified or supplemented by the Executive Board during the operation of the CSF as a condition for approving the availability of CSF resources or completing reviews under the arrangement. It would normally be expected that a Resident Representative would be in place to facilitate close monitoring and compliance with the reporting requirements.

e. Activation and use of CSF

Activation of the CSF element of an arrangement would be based on a determination by the Executive Board that the conditions are appropriate. In assessing whether to activate the CSF element, the Executive Board would consider whether the exchange rate policy was realistic and sustainable; whether the exchange rate policy would be firmly supported by fiscal and monetary policies, including rapid policy adjustments, as necessary; whether the program is fully financed; and, whether adequate monitoring and reporting procedures are in place and functioning properly.

Upon activation, access to the first tranche would become available. The first tranche would represent a form of working balance, which could be purchased and held for the duration of the CSF or drawn, repaid, and redrawn again without the need for further review by the Executive Board so long as the member remained in compliance with the arrangement, including supplementary measures (objectively defined) as might be required by the Board in connection with the CSF element, such as reporting requirements. Decisions to make available CSF resources beyond the first tranche would also be made by the Executive Board and would take into account, inter alia, assessments of monetary, fiscal, and exchange market developments and the sources of exchange market pressure; evaluation of past intervention operations and use of CSF resources; evaluation of the stance of monetary and fiscal policies, including adherence to performance criteria under the arrangement; continued compliance with the conditions of integrated foreign exchange management; continuous adherence to reporting and monitoring requirements; and any other conditions set out at the establishment of the CSF. Policy adaptations could be required. Upon approval, resources in the upper tranches would remain available for purchase for a period of two weeks. At any given point in time, if the member's outstanding credit under the CSF fell into a particular tranche, the maximum size of a request for availability of resources would be equal to any amount remaining unused in that tranche or the size of the subsequent tranche, whichever is larger. Drawings beyond the first tranche would normally be for the purpose of replenishing some pre-established proportion of the member's own reserves used in intervention.

f. Repurchase/Reconstitution

CSF purchases would be subject to a one-year repurchase obligation in those cases where Article V, Section 4 is applicable. A one-year repurchase expectation would apply to those first CSF tranche purchases that are not subject to Article V, Section 4. In addition, CSF purchases beyond the first tranche would be subject to a repurchase expectation that would provide for repurchase within three months; requests for extension of such three-month repurchase expectations would be permitted, with approval of the Board, up to three extensions, so long as the CSF remained in operation. Consideration of requests for extension of repurchase expectations would take into account the same factors relevant to requests for availability of CSF resources. Failure to comply with a repurchase expectation would preclude further use of the Fund's general resources until the repurchase expectation had been satisfied. Failure to comply with a repurchase obligation would result in an overdue obligation to the Fund with all the usual consequences.

Repurchase of a purchase under the CSF element of the arrangement would reconstitute the member's right to request the availability of resources under that element, subject to the conditions for such requests noted above.

g. Charges

Charges associated with CSFs would be the same as those that pertain to stand-by and extended arrangements.

h. Operating procedures

Procedures for handling Fund operations under CSFs would include:

On establishment of a CSF element within a Fund arrangement, a monthly report would be circulated to the Board providing a one page summary of recent developments and prospects, a table of selected CSF-related economic indicators, and a brief assessment of whether the member remains in compliance with all terms and conditions of the CSF and the related arrangement; updates would be provided between monthly reports if CSF resources were used for sustained intervention. If called for, these reports would be supplemented on occasion by somewhat longer reports for discussion. All data and information circulated in these reports would be treated with the utmost confidentiality. CSF-related material would also be covered in the staff reports for reviews under the arrangement.

The Board would be notified immediately of a member's intention to request availability of CSF resources. The minimum circulation period for the Board to act on a member's formal request for the availability of CSF resources would normally be five working days. Under emergency circumstances this could be compressed to 48 hours or, possibly, in informal consultation with the Board, a shorter period.

After a request for the availability of CSF resources is received, the staff would circulate as soon as possible an updated summary of the economic situation and a staff assessment of compliance, to be supplemented as necessary by a briefing at a Board meeting. Under normal circumstances, the period between circulation of the updated summary and the Board discussion of the request would be at least 48 hours. However, under exceptional circumstances, the circulation period could be abbreviated. Disbursement procedures would be in keeping with the Fund's Rules and Regulations, i.e., normally requiring three business days from initiation of a purchase.