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Reducing Vulnerabilities: The Role of the Contingent Credit Line

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IMF Tightens Defenses Against Financial Contagion by Establishing Contingent Credit Lines
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Introduction

Mr Chairman, Ladies and Gentlemen. It is a great pleasure to join you here today.

Unfortunately, we meet at a time of considerable uncertainty for the world economy, and for Latin American economies. Our best current guess is that the slowdown now under way will be relatively brief and not turn into a recession. But there is clearly a risk that the downturn could be deeper and more prolonged.

It would be natural today, at this time when so many policymakers feel vulnerable to what is happening in the global economy, or in their neighbors' economies, to discuss in detail the global economic outlook. At the end of my presentation, I will very briefly mention the state of the IMF's discussions with Turkey and Argentina, and make a short comment on the potential role of the Fund at this time of uncertainty.

But for the most part, I want to focus on one way in which the IMF can in future contribute to reducing vulnerability and bolstering investor confidence in emerging markets: through our strengthened Contingent Credit Line facility. It is precisely at a time like this that the CCL could be playing a critical role in helping protect economies from contagion - and through its encouragement for good policies helping reduce the extent and intensity of contagion.

The Contingent Credit Line Facility

Capital Flows and Crisis Prevention

The huge expansion of international capital flows of the last decade has delivered significant economic benefits to borrowers and lenders alike. But as we have seen all too often in recent years, this silver lining has a cloud. Countries have been exposed to periodic crises of confidence

when large inflows of capital suddenly go into reverse. As capital flows have increased relative to the size of national economies, so too has the disruption that such reversals can cause.

The spread of financial crises is far from random: contagion tends to hit weaker economies more quickly and more forcefully than strong ones. But even so, it is hard to believe that the speed and severity with which crises spread can be justified entirely by economic fundamentals. The contagion to Latin America from Russia's financial crisis in August 1998 is a case in point. One reason to take excess contagion seriously is that an investor panic can itself push an economy from a good to a bad equilibrium: when a country's policies and institutions are subjected to pressure from a reversal of capital inflows, they may crack, appearing in retrospect to justify the reversal of flows that caused the crisis to begin with.

Because crises appear to be a function of both policy weaknesses and excess volatility and contagion, the international community has adopted a twin-track approach in its crisis prevention efforts: first, helping countries identify and correct policy problems that leave them vulnerable to crises, and; second, providing offers of financial assistance to countries that already have good policies but which nonetheless fear falling victim to contagion.

As its contribution to the first track, the IMF has stepped up surveillance of national policies and international markets, focusing on potential weaknesses that might leave a country exposed. These include poor macroeconomic policies, unstable exchange rate regimes, unsound debt management, and weak financial sectors. Countries are also being encouraged to conform to international standards and codes of conduct. And to make their policies and economic developments as transparent as possible, so that investors are able to take well-informed decisions and are less likely to be confronted by disruptive surprises. By increasing the discipline to which authorities are subjected by their peers, by market participants, and by the international community, transparency provides a powerful spur to good policymaking.

Structure and Principles of the CCL

The CCL contributes to the second track - that is, it deploys the IMF's financial resources to assist countries with good policies that nonetheless fear contagion. The basic idea is straightforward: the IMF offers a precautionary line of credit to countries that have met certain preconditions. The line of credit in effect augments - at remarkably low cost - the foreign exchange reserves they can draw upon in a crisis. The knowledge that these resources are available may in itself deter a speculative attack. By offering qualifying countries a seal of approval for their policies, it also reduces the chance that investors and creditors will pull their money out indiscriminately because of crises elsewhere.

This marks an important departure from the Fund's traditional lending activities. Rather than waiting to pick up the pieces after an accident has happened, the CCL means that the Fund's lending capacity can be used for crisis prevention, as well as crisis resolution. This obviously creates a risk of moral hazard. Countries have an incentive - in theory at least - to run weaker policies if they have an extra financial cushion in place. Perhaps more importantly, investors have an incentive to lend to countries with weaker policies if they believe that the presence of the credit line increases the chances that they will be repaid if things go wrong.

To counter this problem, the CCL is aimed explicitly at members with "first-class" policies, who face a potential loss of access to international capital markets because of contagion rather than domestic policy weaknesses. But we do not live in a Manichaean world in which we can divide countries neatly between the righteous and the ungodly. So "first-class" should not be taken to mean "perfect". The eligibility criteria are demanding, but they are not Groucho Marx-like in preventing any country that might benefit from the CCL from signing up for it.

Let me discuss them briefly in turn:

- First, at the time the credit line is extended, the recipient country must not be expected to need to borrow from the Fund. This implies that over the medium-term the country should be expected to be able to finance its balance of payments comfortably, based on a realistic assessment of its access to private capital and a sustainable projected path for external debt. Risk scenarios and sensitivity tests would be used to establish the strength of the country's external position.

- Second, our Board must have made a positive assessment of both the country's economic prospects and its progress towards meeting international policy standards:

    At the very least, this means that the policies a member has been pursuing in the recent past - and intends to pursue in the future - should not expose it to a significant risk of balance of payments pressure. But "positive assessment" does not mean an assessment devoid of any policy recommendations. Ideally, it would be desirable to judge a country's economic prospects against transparent and predetermined numerical hurdles for key indicators. But in practice the significance of those indicators will depend on individual country circumstances. For example, a high current account deficit relative to GDP might be a problem in one country, but not in another where it is primarily financed by foreign direct investment.

Four international standards are key: (i) the Special Data Dissemination Standard, (ii) the Basel Committee's Core Principles for Banking Supervision, (iii) the Code on Fiscal Transparency, and (iv) the Code on Transparency in Monetary and Financial Policies. Countries must be making satisfactory progress towards meeting the data standard to qualify for a CCL; the other standards are judged as a group and the country must be making adequate progress towards meeting a critical mass of them if it is to qualify.

- Third, the country must enjoy constructive relations with its private creditors and be taking appropriate measures to limit its external vulnerability.

Constructive relations means in the first instance that the country must not be in arrears on sovereign debt or or private debt arising from exchange controls. Credible efforts to facilitiate the participation of private sector creditors might include some of the following: contingent private credit lines, debt issued with an option to extend the maturity, debt issued with collective action clauses to restrain rogue creditors, a framework for debtor/creditor discussions, a strong bankruptcy regime and effective debt management procedures. Credit rating agencies and bond spreads give a useful guide to the state of relations with private creditors, but countries do not have to be investment grade to qualify for the CCL.

Several factors need to be looked at in judging whether a country has taken appropriate steps to limit its external vulnerbaility. These include the nature of the exchange rate regime and whether the currency is overvalued. They also include the sustainability of its public and total external debt, which means looking at the structure of the debt in terms of maturity, currency and possible credit enhancements. Other indicators include the adequacy of external reserves relative to expected imports and short-term debt. The more flexible the country's exchange rate regime is, the fewer reserves it needs. The net foreign asset position of commercial banks and the presence of significant off-balance sheet items also need to be looked at.

- Fourth, the country must outline to the Board the policies it intends to pursue during the one-year period covered by the CCL. These have to be supported with a quantified quarterly program that covers the outlook for fiscal policies, monetary policy and the balance of payments. However - and this is an important difference from post-crisis programs supported by the Fund - there

would be no formal performance criteria or benchmarks against which performance would be assessed.

One criticism of the CCL is that it would be very difficult for the Fund to withdraw a country's access to its credit line if the quality of its policies slipped after it had been in place. The assumption is that the Board would fear triggering a crisis by publicly signalling its disquiet. To some extent, this problem is inherent in the way the CCL works: access to the facility is not much use as a seal of approval if its withdrawal sends no signal at all.

But the problem should not be exaggerated. The policy slippage would be unlikely to come as a complete surprise to the markets, which helps explain why market reaction is normally fairly muted on the many occasions when negotiations to renew an existing traditional Fund program are suspended because policies have gone off track.

But if the quality of policies is as clear to the private sector as it is to the Fund, why should the task of providing contingent credit lines not be left to the private sector? Argentina, Mexico, South Africa and Indonesia have all arranged lines of credit with private banks to draw upon in times of trouble.

In practice, countries have had difficulty using these credit lines. Mexico decided to draw on its credit lines in the wake of the Russian crisis, a decision clearly in line with the terms of the arrangements. But it could only do so in the face of strong opposition from the banks, which argued that to do so would undermine the country's creditworthiness. Yields on the country's debt did indeed rise when the lines were drawn upon, but quickly fell back.

The value of private credit lines can also be undermined if lenders engage in dynamic hedging, in effect taking with one hand what they give with the other. Dynamic hedging can also fuel contagion if lenders forced to increase their exposure to one energing market country respond by reducing their exposure to others.

Experience with the CCL

In the first year of the CCL's existence, several countries discussed with Fund staff whether they should apply for one. But in the end none took the plunge. Potential users pointed to several weaknesses in the original design, prompting our Board to make important changes to the facility late last year. Two were particularly significant: the pricing of the facility and the mechanics of drawing on it. Let me describe the changes briefly.

- First, the pricing. In the original design, CCL loans - if drawn - would have been priced at the same rate as loans under our

Supplemental Reserve Facility, which was created in 1997 to make relatively large short-term loans to countries hit by capital account crises. But since the international community should support countries that adopt policies to limit their vulnerability to crises, it is reasonable to impose lower charges on countries that take those steps to qualify for the CCL. The surcharge over our normal loan rate has now been reduced to 150 basis points, rising to 350 basis points with the duration of the drawing.

- Second, there were concerns that countries which had already been granted a CCL were made to jump too many extra policy hurdles to get their hands on the money when they needed it. In the light of the strong policy track record required to qualify for a CCL, the Board has agreed to make payment more automatic for the first third or so of the resources committed under the facility. In particular, the Fund will give countries "the strong benefit of the doubt" as regards their future policy intentions.

In addition to these weaknesses, countries have probably been deterred from applying for the CCL by two other factors: the global economic environment and uncertainty about the reaction of the financial markets to an announcement that a country has asked for a CCL.

On the first of these points, many countries no doubt felt through late 1999 and most of last year that the global economic environment had become relatively benign in the wake of the crises. Gross inflows of private capital into emerging markets were recovering, reflecting improving macroeconomic fundamentals in the emerging markets, healthy world growth and favorable liquidity conditions in the advanced economies.

But conditions have certainly become more difficult for emerging markets this year, notwithstanding falling interest rates in the industrial countries. World growth has slowed sharply, financial and commodity markets are volatile, and investors are concerned by events in Turkey and Argentina. All this has created an uncertain environment for emerging market financing. The CCL is a useful insurance policy to have in place when the waters are entirely calm - even more so now that they have become a little more choppy.

On the second point, some countries have clearly been concerned that applying for a CCL might be seen as a sign of weakness by financial markets, rather than one of strength. The markets should not take this view, for two reasons: first, the stringent prequalification requirements should signal that the country's economy is strong; and second, access to the CCL is in effect a way of adding to reserves at low cost - and the markets generally regard higher levels of reserves favorably. The Fund has been stepping up its dialogue with private sector financial institutions in recent months, through the Capital Markets Consultative

Group, to name one channel. We are using this dialogue to educate the private sector about the CCL, which should mean that it is received favorably.

Inevitably, the problem here is that countries are reluctant to be the first to adopt the CCL. Once one has jumped into the water and it becomes clear that the medicine repels rather than attracts the sharks, others will no doubt feel less anxious. The Mexican government has already announced that it is interested in obtaining a CCL, and we are discussing that with them. So they could lead the way. A number of other countries have also expressed interest, so another possibility would be for a group to decide to adopt the CCL together. We are looking at that option too.

All in all, it is quite possible that within a few months, more than one country will have taken up the CCL, and that we will be wondering what all the fuss was about. I am absolutely convinced that the facility is a valuable long-term addition to the international community's crisis prevention arsenal, and to building up member country's defenses against contagion.

Postscript

Let me conclude with a few words on Turkey, Argentina, and the Fund's readiness to help member countries:

Our negotiations with Turkey are virtually complete, and only final details of the economic program and the financing for it remain to be determined. The Turkish authorities in the negotiations we have been conducting with Minister Dervis and his colleagues have demonstrated their determination to continue on the path of stabilization and reform on which they started at the end of 1999, and to take all the measures - including very tough measures to restructure the banking system and fiscal measures that will ensure a rapid turnaround in the debt situation - necessary to restore stability and continue the process of disinflation. Turkey could have inflated its way out of this crisis, and has decided not to. Turkey deserves the support of the international community, and it will get it.

The dramatic situation in Argentina continues to dominate attention in Latin America. Minister Cavallo has announced that Argentina intends to meet the fiscal targets established last December, and by instituting the financial transactions tax, has taken a major step towards making that possible. He has reaffirmed his determination to preserve convertibility and meet Argentina's debt obligations. On that basis, our team in Buenos Aires is making progress in its negotiations to reformulate the program. The team will come back in a few days to continue the negotiations with Minister Cavallo and the rest of the Argentinian team, who will be here to attend the spring meetings.

Finally, let me make clear that the IMF stands ready to do its job, in helping any member country willing to adopt the right policies. In the words of Article I of the Articles of Agreement, which defines the purposes of the Fund, we are ready

> To give confidence to members by making the general resources of the Fund temporarily available to them, ... thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

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[1] Remarks prepared for delivery to the Latin American Central Bank and Finance Ministry Network, at the Inter-American Development Bank, Washington DC, April 25, 2001. Views expressed are those of the author, and not necessarily of the International Monetary Fund. I am grateful to Robert Chote for his assistance.

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