The IMF Reserve Augmentation Line Proposal: Contingency Financing for Middle Income Countries with Access to Private Capital Markets

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As a result of the increased integration into international capital markets in the 1990s the International Monetary Fund proposed a series of special facilities to support emerging market countries facing capital flow reversals. The most recent is a 2006 Fund proposal for the Reserve Augmentation Line (RAL).[i] It provided for a pre-commitment of Fund resources by qualified countries in the case of a loss of confidence due to contagion from an external event. It is intended for use by countries that do not need, and are not anticipated to require, IMF liquidity support, have proven policy credibility, and need no adjustment in their macroeconomic policies. They are also expected to have debt management policies that produce sustainable debt profiles.

The RAL qualification procedure is not only based on past policy performance, but more importantly on forward-looking policy planning. In addition, qualification may be extended to countries dealing successfully with existing balance sheet vulnerabilities. The pre-commitment of exceptional access in the proposal is 300 per cent of quota, and disbursement would be automatic in the case of need.

However, there are still limitations in providing the kind of rapid support that members might expect in order to respond to contagion from an external financial crisis. While the amount and timing of the disbursement is fixed, the amount seems small relative to past experience. Paradoxically, the fee structure proposed for the RAL appears to restore a negative aspect of a prior proposal – the precommitment fee for the facility can only be recovered if the exceptional access is actually disbursed.

The post-disbursement review and semi-annual monitoring of the country's policies may also recreate a negative announcement effect if the proposed post-disbursement review determines that the conditions facing the country were not appropriate for an RAL drawing and the country is required to apply and be reviewed for an Supplementary Reserve Facility. Since this means that the SRF may be less costly in financial and market sentiment impact, it may be more appealing for a country to assess the consequences of an external contagion on its performance and then apply for an SRF.

As with any draft proposal, there are a number of unresolved issues. The proposal calls for a sustainable debt profile, but provides no definition of sustainability and does not indicate the kinds of policies that should be employed in the case of an external shock to ensure sustainability. The traditional approach involves the ability of a country to reduce domestic absorption sufficiently to meet external commitments without domestic disruption, however other measures, such as the ability to maintain a sustained growth in per capita incomes, have recently been proposed.

While disbursement is automatic and without further review, there is no discussion of the determination of the "need" for resources required to trigger disbursement. Given the proposed post-disbursement review, it should be supposed that this would be on the simple request of the country, but it is not clear from the proposal.

Many countries that would qualify for the facility face a rather different form of contagion from that discussed in the proposal. Instead of loss of confidence, they suffer from excessive private inflows that disrupt domestic policy stability. This raises the question of whether policies centered on the overall management of capital flows should not be part of the forward-looking policy commitment required for qualification for the facility.

The proposal suggests that the facility "be designed to limit the possibility that the Fund will be called upon to provide financing in a situation where the member is unlikely to take the appropriate policy action to address the shock" However, if qualifying countries already have acceptable present and precommitted future policies and the disruption is due to contagion from external causes, what additional "appropriate action" is required? Additional Fund conditionality is usually required to counter the moral hazard that a country will use Fund resources to avoid undertaking policies to adjust to external disequilibrium – the proposal speaks of "reckless behaviour" on the part of borrowers from the facility, but in this case the problem is not caused

by deficient behaviour domestic policies, so it is not clear what appropriate policy reaction is required to respond to the shock. Indeed, if the cause of disequilibrium is purely external, active counter-cyclical policies might be more appropriate than imposing increased effort to maintain existing policies. "Appropriate" policy action is not specified in the proposal.

The proposal also mentions the need to guard against moral hazard on the part of lenders who may be looking for a Fund guarantee to liquidate their credits to the country. Here there appears to be some confusion, for this is precisely what the facility is meant to do – convince existing and potential creditors that their positions are without risk, which means that as under normal conditions they will be able to exit if they deem necessary.

More generally, if disruption is clearly due to contagion from external sources, rather than to domestic policies, it would seem appropriate to offer support to all market access countries not currently in an IMF arrangement subject to risk of contagion.

Attention is also given to including in the proposal "elements that limit the risks to the Fund's resources and reputation that could arise if the Fund disburses in adverse circumstances." However, if the facility is to be credible, is must disburse in adverse circumstances that may place the Fund's resources and reputation at risk. Indeed the proposal is based on an assessment that Fund conditionality can improve a country's ability to weather a contagion crisis that is far from certain. However, as noted above, any reticence in the Fund's confidence in the success of the facility simply undermines its probability of creating market credibility and its probability of success.

It seems clear that the RAL is meant to respond to the calls that have been made for the IMF to take on the role of global provider of liquidity by acting as a global Lender of Last Resort (LLR) – a function that was excluded by the decision taken at Bretton Woods not to create an international central bank. Rather, the original role of IMF was to reduce the necessity for member to commit domestic resources to stabilize exchange rates by providing for a sharing of risk through the pooling of foreign exchange reserves. It originally was designed to provide automatic access to liquidity reserves, up to a member's quota, when required. This might be called a quantity "constrained" LLR whose ability depended on keeping quotas increasing with the liquidity needs of countries. However, the introduction of Fund conditionality reduced the automaticity, and the size of private capital market financing made the required increase in quotas politically unobtainable. Thus the erosion of the benefits of the pooling of reserves to reduce the risk of financial instability that can be seen in the continuous increase in members' holding of foreign reserves that might be better used for other purposes.

Credible reduction of the risk of contagion for both IMF members and for private market lenders thus requires that the IMF restore its ability to act as a constrained Lender of Last Resort. This would require an unlimited ability to create and disburse liquidity as would have been available under the original US proposal for a single world currency or the British proposal for a clearing union. In its absence, substantially larger quotas, to meet the likely size of capital flow reversals and speculative position would be required. An alternative would be a substantial increase in automatic special agreements to borrow from developed countries that have followed the G-10 GAB. However, this is unlikely to be acceptable to either potential borrowers or potential lenders, as it would mirror the action of a clearing union without introducing adjustment asymmetry.

There thus seem to be structural and political difficulties that prevent the Fund from providing the kind of liquidity instrument that would provide the kind of protection required by market access countries to reduce the risk of instability from financial contagion.

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[i] References to the RAL are to the specific proposal for discussion contained in the Staff paper "Consideration of a New Liquidity Instrument for Market Access Countries," prepared by the Policy Development and Review Department, In consultation with other Departments, Washington D.C.: International Monetary Fund, August 3, 2006.