

IMF FINANCIAL FACILITIES: SIGNALLING VERSUS INSURANCE

IMF financial facilities: signalling versus insurance

This article has been prepared by Javier Díaz Cassou, María Jesús Fernández and Santiago Fernández de Lis, of the Directorate General International Affairs.

Introduction

Since 2005 the IMF has been reviewing its medium-term strategy, largely in response to the debate on its role in the financial crises of the late 1990s and early 2000s. Globalisation has unquestionably significantly changed the role of the IMF and revealed certain deficiencies in its functions and in the instruments used to carry them out. This debate has prompted reflection on its role in an international economy in which a formal framework of co-operation barely exists between the national authorities and in which the growing financial integration has enabled many emerging economies to benefit from unprecedented access to the financial markets, but which is highly vulnerable to sudden reversals of capital flows. Some of the matters addressed in recent months as part of this strategic review are: the role of official financing in crisis prevention and resolution; how the IMF should respond in a situation such as the present one, characterised by growing global imbalances; and the build-up of reserves in a good number of emerging economies, which, on the one hand, denotes a desire for self-insurance so as not to depend on the IMF and, on the other, tends to aggravate these global imbalances¹. The early repayment by Brazil and Argentina of their outstanding debt to the IMF in late 2005 and early 2006, respectively, added fuel to the debate on its role in the financing of countries in crisis.

In general, the IMF's crisis management has drawn criticism from both borrowers and lenders. For creditor countries, the large rescue packages have contributed primarily to distorting incentives, both those of investors (for proper risk assessment) and those of the country authorities (for adopting appropriate economic policies). In the opinion of the borrower countries, however, the IMF's financial programmes have tended to impose excessively stringent domestic adjustment, and the volume of assistance has not been sufficiently predictable nor have the terms been adapted to the circumstances of each crisis.

One of the most interesting discussions regarding the role of official financing in emerging economies is to what extent there is a gap between the surveillance and financing functions of the IMF that could make it advisable either to strengthen its signalling role, i.e. its ability to provide signals about its members' economic policies that affect the decisions of international investors, or to broaden its range of financing facilities by adding an insurance-related instrument so that, in the event of adverse exogenous shocks, IMF members have assured access (under certain conditions) to its funds that is predictable in regard to volume and maturity.

This article briefly describes the context and terms of this debate, because of its topicality and significance within the discussions on international financial architecture.

The role of official financing in international financial architecture

The first manifestation of the impact of globalisation on the nature of balance of payments crises in emerging economies was the Mexican crisis of 1994-1995. In response to this crisis, the IMF led a rescue package unprecedented in the history of the international financial system: nearly USD 48 billion (USD 18 billion provided by the IMF itself), equal to 688% of its

1. See IMF (2005).

quota². A few years later, the IMF granted further extraordinary financial packages in the 1997-1998 Asian crisis: USD 21 billion to Korea, equal to 1,940% of its quota; USD 10 billion to Indonesia, equal to 490% of its quota and USD 4 billion to Thailand, equal to 505% of its quota³.

In view of the virulence and increasing frequency of these capital-account crises, the IMF decided to equip itself with new instruments. First, a new financing facility, the supplemental reserve facility (SRF), was developed to meet needs for large-scale, short-term financing derived from a sudden reversal of capital flows. And second, an insurance instrument known as the contingent credit line (CCL) extended the IMF's financial role to the area of crisis prevention, providing a certain degree of assurance against the systemic effects of financial crises. This demonstrates the importance given in the late 1990s to the provision of official financial assistance in constructing a new international financial architecture and which crystallised in proposals to consolidate the IMF as a quasi-lender of last resort at international level, adopting a similar role to that of central banks at national level⁴.

However, as the IMF made increasingly large financing packages available to countries, sharp criticism began to be heard that the funds were being used mainly to repay debt to private lenders and release them from assuming their part in the cost of financial crises, thereby contributing to distort the private sector's incentives to properly assess the risk of its international lending (moral hazard). It was argued that the distortion of incentives was also observable in the authorities of the emerging countries themselves, which tended to adopt more lax economic policies in the knowledge that the IMF would bail them out.

The debate on the moral hazard potentially created by IMF programmes, along with the fact that the IMF could not provide sufficient funds to act as a lender of last resort, led the international community to reconsider the framework for crisis resolution and to adopt two significant measures to reform it. First, as a result of the debate on the role of the private sector in crisis resolution, the so-called Prague framework⁵ was adopted in 2001. It established that the public sector and the private sector have to assume their respective shares of the financial cost of a crisis when it occurs. The objective pursued was to balance the contributions of these two sectors in resolving a crisis and consolidate market discipline as the key to the functioning of the international financial system. Second, in relation to access to IMF resources, the policy of exceptional access was adopted in 2002. This policy aims to constrain the discretionality with which the IMF had until then granted funds above the normal access limits and, at the same time, to enhance the clarity and predictability of the system. Consequently, from that time certain conditions were set for access to funds in excess of the limits, namely that: i) the country is under extraordinary pressure on its balance of payments, ii) its level of debt is sustainable, iii) there are grounds for considering that the country will regain access to the markets before the programme expires, and iv) the conditions exist for adequately implementing the adjustment policies associated with the IMF programme. Also, an "exceptional circumstances clause" was included to cater for cases in which none of these conditions was met.

2. Member countries have access to IMF funds based on their quota. According to the normal access limits, a country can access in one year a volume of funds equal to 100% of its quota and it can access 300% cumulatively over three years. 3. These IMF programmes were supplemented with funds from the Asian Development Bank, from the World Bank and bilateral aid to make up rescue packages amounting to USD 57 billion in the case of Korea, USD 36 billion in Indonesia and USD 16.7 billion in Thailand. 4. See Fischer (2000). 5. The crisis resolution framework agreed upon in Prague establishes that the financing needs arising in a balance of payments crisis should, after deduction of the related domestic adjustment, be covered by the following components: i) provision of official financing; ii) "spontaneous" catalysis of private financial flows, and iii) the more or less coercive assumption of losses by the private sector (private sector involvement).

In short, since 2000 the international community has sought to reduce the weight of official financing in crisis resolution. That said, the practical application of this policy has caused controversy. Some cases that have raised doubts regarding the application of this framework are: i) the extension in 2003 of the 2002 Brazilian programme, which, as a preventive project, in principle lay beyond the bounds of the exceptional access policy, since the pressure on the balance of payments was “potential” rather than real; ii) the 2003 Argentine programme, which was granted despite the evidence that the country’s debt balance was unsustainable; and iii) the 2005 Turkish and Uruguayan programmes, which were granted in the absence of extraordinary pressure on their balance of payments.

The difficulty in applying strictly the exceptional access policy has made plain the problems in consistently applying the crisis resolution arrangements that had been designed and has rekindled the debate on the role to be played by IMF financing in the international financial architecture. For some, limiting the moral hazard problems continues to be the priority and, consequently, they defend the setting of limits on the IMF’s financing capacity, a strict application of the Prague Framework and of the exceptional access policy and a strengthening of its surveillance – or signalling – function. Others, however, see the existence of market failure in the international financial system and the systemic effects of financial crises as reasons for strengthening the international financial system’s safety nets and they defend the creation of a new insurance instrument as a means of preventing and, possibly, resolving crises; in their opinion, the difficulties encountered in applying the exceptional access framework are not so much due to inappropriate application as to inadequate design.

***The terms of the debate:
signalling versus
insurance***

Two of the most important functions carried out by the IMF are signalling and insurance. Signalling refers to the IMF’s ability to send out signals that influence the decisions of international investors or of the donor community (in the case of low-income countries) by giving a “stamp of approval” to the policy framework of its member countries. Basically, the IMF provides signals through: i) its surveillance instruments, e.g. its yearly reports on the economy of member countries⁶, and ii) the programmes and subsequent reviews of compliance with the conditions⁷ of these programmes. Insurance refers to the possibility of access to IMF resources that member countries have (based on their quota) and that provides them with some “insurance” against possible balance of payments needs.

The process of financial globalisation has heightened the importance of both functions, particularly because such adverse effects can be caused by sudden reversals of capital flows, as, for example, in the case of those that affected a certain number of emerging economies from the mid-1990s. That said, the international community does not have a unanimous stance on the weight that each of these functions should have in the new international financial architecture. Put plainly, this means there is no consensus on the role that should be played by official financing in crisis prevention and resolution in a globalised environment. The debate on the weight that the IMF should give to its signalling function as compared with its insurance function in emerging economies is due to differing views on such important underlying matters as: i) the origin and nature of balance of payments crises in these economies, ii) the impact of IMF financing on agents’ incentives, iii) the catalytic effect of its intervention on private financial flows, iv) the IMF’s financial capacity, and v) the desires of emerging countries in an increasingly globalised international economy.

6. These documents are called reports pursuant to Article IV. 7. See Serra (2003).

It is generally acknowledged that two key factors explain the dynamics that have characterised financial crises in the past decade: i) the application of inconsistent macroeconomic policies, and ii) the existence of failures in the functioning of international financial markets. Having said that, the same consensus does not exist on the relative importance of each of these factors. Those who consider that failures in economic policy are the primary cause tend to defend the strengthening of signalling mechanisms to enable international investors to distinguish better between countries committed to a sustainable policy framework and those that are not, in the belief that market discipline will act to reward the former and penalise the latter. Nevertheless, those who consider that market failure is the main cause tend to defend the need to improve insurance mechanisms, since they feel that capital account liberalisation and international financial integration may entail highly significant risks for emerging economies over which at times the authorities have little influence.

Two reasons lie behind the IMF's need to devise signalling mechanisms: information asymmetries and the strengthening of incentives to adopt sound economic policies. Firstly, if the actions of a country's authorities are not directly observable by international investors, those authorities would have an incentive not to keep the promises made to attract foreign investment, which in the long run would tend to reduce capital flows to emerging markets. Naturally these lesser capital flows would have a high cost in terms of lower economic growth, less efficient financial intermediation and worse allocation of resources at international level. Secondly, the logic of a signalling mechanism lies in the desirability of giving member countries an incentive to demonstrate their commitment to implementing an adequate combination of economic policies. In principle, if signalling mechanisms worked properly, the authorities would have to assume a more palpable and immediate cost for straying from this policy framework⁸.

For its part, an insurance mechanism is desirable because of the problems of multiple equilibria that tend to affect emerging markets when they face a liquidity crisis. Owing to a lack of co-ordination between creditors, if a liquidity problem arises, these tend not to grant an extension of loan maturities, despite the fact that arranging this extension collectively would mean that the country's situation could be improved and the cost to be borne by the various parties involved would be lower. This problem of lack of co-ordination is aggravated by the self-confirming nature of financial markets' expectations, in that, as investors lose confidence in a country and capital outflows begin, the situation worsens and the process tends to feed back on itself. Under this interpretation of balance of payments crises, it is also argued that information problems prevent investors from distinguishing between a situation of illiquidity and one of insolvency, thereby activating the adverse market dynamics described above. An insurance mechanism would help to "co-ordinate" the agents, and this co-ordination would prevent such market dynamics from being activated and a liquidity crisis from resulting in insolvency, with its much greater economic cost.

As mentioned above, much of the debate on the reform of international financial architecture has centred on the moral hazard problem posed by IMF programmes, basically those provid-

8. Insofar as low-income countries are concerned, the enhancement of the IMF's signalling role has a different rationale. In these countries, international private financial flows have a marginal importance compared with official development aid. In this context, IMF signalling is basically intended to show how the task is to be divided up within the official sector. The IMF would focus on establishing a macroeconomic conditionality that provides donors with a certain assurance of the sustainability of the countries' policies. The funds would be provided by donors, rather than the IMF, because, among other reasons, balance of payments disequilibria in these countries tend to be due to structural factors requiring longer-term development projects and strategies more suited to the mandate of institutions like the World Bank or regional development banks.

ing exceptionally high access to its funds. This line of argument led to the constraint of IMF financing as a result of the Prague Framework and the exceptional access policy. More recently, the discussion on the introduction of programmes without financing constitutes another step towards reducing the role of IMF financing and enhancing its signalling role. The aim is to limit moral hazard problems and consolidate market discipline as a key factor in the formation of agents' expectations and incentives.

However, the empirical findings on moral hazard induced by the IMF do not support the foregoing line of argument. The literature, which has concentrated on analysing the moral hazard of creditors, has studied the impact of IMF programmes on sovereign spreads and the price of certain financial assets and, in general, has not found any solid evidence for the existence of a significant moral hazard problem. There does, nonetheless, seem to have been a moral hazard problem in the Asian crisis, partly because of the precedent set by the 1995 Mexican rescue. However, the decision not to grant a financial programme to Russia in 1998 (a country that in principle seemed "too big to fail") possibly led to reconsideration of international market expectations on the availability of official financing for countries in crisis, and even more so following the 2001 Argentine crisis. The empirical literature, although not unanimous, tends to confirm this impression: following the experience of Russia, international investors have discriminated more finely between emerging markets, paying greater attention to the performance of their fundamentals and hence assessing their risks more accurately. These developments may be related to the improved transparency seen since then⁹.

Additionally, it has been argued that moral hazard is an inevitable characteristic of any type of intervention aimed at mitigating a certain "catastrophe risk", although this does not justify a policy of "non-intervention". A certain moral hazard associated with the presence of the IMF as a mechanism of international financial protection should, according to this line of argument, be accepted in the same way as one accepts at domestic level the moral hazard derived from the role of central banks as lenders of last resort or from deposit insurance mechanisms. This does not mean that measures should not be taken to mitigate the distortions to agents' incentives that may be generated by the IMF's protection mechanism. But the objective of reducing the moral hazard associated with IMF financing should be balanced with other objectives of the IMF, such as the strengthening of international financial stability or crisis prevention and resolution. In other words, it is necessary to achieve a balance between "moral hazard" and "catastrophe risk", taking into account that the measures designed to reduce one of them often increase the other.

These arguments and empirical findings are cited by the proponents of strengthening the insurance role of the IMF. They insist that the importance of moral hazard has been overstated and that not all the effects of IMF financing on agents' incentives are negative. If country authorities assess the costs and the benefits of financial integration in the world economy, the presence of a safety net provided by the IMF's insurance function could tip the balance towards a deepening of the processes of financial liberalisation. This would both benefit emerging economies, which would presumably obtain greater volumes of international investment, and improve the functioning of the international financial system, since it would enable better diversification of risks worldwide.

CATALYTIC EFFECT OF THE IMF

The importance of the IMF's signalling role is based mainly on the premise that the IMF can significantly influence agents' decisions by providing signals such as the dissemination of the

9. Regarding this improvement in transparency, see M. de Las Cases, S. Fernández de Lis, E. González-Mota and C. Mira-Salama (2004).

results of bilateral surveillance, the announcement of a programme or the favourable review of compliance with its conditions. One of the main reasons is that the information has some of the features of a public good, so agents tend to devote a very few of their resources to obtaining it and to resort to the reports of third parties for making their investment decisions. This problem is aggravated in transnational financial transactions by the fact that the information is more dispersed and difficult to obtain, particularly in the case of emerging economies and low-income countries, which tend to be less transparent and have lower quality economic data. This market failure in regard to information would justify public intervention and the IMF, in view of its intellectual heritage, its global nature and its mandate, would seem to be the most appropriate institution to act as “delegate assessor” on behalf of market agents, by providing signals on the economic condition of its member states.

However, empirical findings on the IMF’s catalytic role do not seem to support this idea. Most studies find that the IMF has tended to overestimate its catalytic impact, and only in very specific circumstances of countries and depending on such matters as a country’s relationship with the IMF and programme conditionality, has any significant catalytic effect been found¹⁰.

Perhaps one of the factors contributing to limit the impact of the IMF’s signals is the increasingly greater availability and quality of private information on emerging markets, which naturally tends to erode the IMF’s informational superiority and therefore its ability to influence private investors. This weakens the argument in favour of introducing facilities without financing, since the greater availability of private information mitigates the asymmetries and market failures that might justify public intervention in the area of signalling. What is more, if empirical evidence shows that the catalytic effect of IMF financial programmes has tended to be smaller than expected, it can be asked what this catalytic effect would be in a programme without financing, even assuming the country in question undertook to meet conditions similar to those of a programme with financing. This assumption is questionable because, without the incentive of the successive payments under a conventional programme, the IMF’s ability to ensure compliance with conditions is weakened.

FINANCIAL CAPACITY OF THE IMF

One of the key points of debate is whether the IMF can provide the funds needed to carry out an explicit insurance function or whether, in contrast, its financial limitations should be recognised and, accordingly, it is preferable to support the enhancement of its signalling function.

Naturally, the IMF’s credibility as an insurance mechanism would essentially depend on its ability to harness funds on a sufficient scale to prevent the dynamic of a self-confirming financial crisis from establishing itself. Unlike other international financial institutions, the IMF functions basically as a “co-operative” and has little capacity to act as a financial intermediary. It has clearly defined financial limitations, which can only be overcome by periodically revising its members’ quotas and, despite its current highly liquid position (which stands at a historical high), the fact is that its relative weight in the world economy has been declining in recent years in line with the rapid growth of private capital flows to emerging countries, which have risen from around USD 15 billion per annum in the 1970s and 1980s to more than USD 200 billion in 2004. The volatility of these capital flows has led to balance of payments problems that have tended to move from the current account to the capital account.

10. Some studies even find that IMF programmes have a negative impact on private capital flows to a country, although this may be due to unresolved matters in the econometric specifications used and, in particular, to problems of sample selection. For an in-depth review of the catalytic effect of the IMF, see J. Díaz Cassou, A. García Herrero and L. Molina (2005).

In view of this, one of the main arguments against establishing an insurance mechanism is that, for it to have a significant impact, the size of the IMF would have to be increased far beyond what can be considered feasible under the current quota system. That said, a counter-argument that has been adduced is that if an insurance mechanism were mainly a crisis prevention instrument, it would probably reduce the frequency of crises and hence would not put overly high pressure on IMF resources. Moreover, as seen in the Argentine crisis, the greater ability of international investors to discriminate between emerging markets has led to the moderation of contagion phenomena, which would also tend to reduce the financial requirements of an insurance mechanism.

DEMAND BY EMERGING
COUNTRIES

There is reason to believe that emerging countries have little interest in a signalling mechanism based on facilities without financing. These countries have scarcely expressed interest in facilities of this type and in some fora¹¹ have even expressed opposition to their introduction. The predominant impression is that in emerging economies, especially the Asian ones, the demand is rather for insurance-type mechanisms designed to limit the risks deriving from sudden reversals in capital flows. Two indications of this are, first, the build-up of reserves by them in recent years¹², and, second, the signature of regional agreements to swap reserves, such as the Chiang Mai initiative¹³. Both developments point to a desire for self-insurance which has been interpreted as a tendency by certain emerging countries to dissociate themselves from the IMF in view of its inability to cater to their needs¹⁴. This impression has grown following the recent decision by Brazil and Argentina to terminate their programmes with the IMF.

***Proposals made for the
introduction of signalling
and insurance instruments***

PROPOSALS FOR SIGNALLING
INSTRUMENTS

Countries agreeing facilities without financing would be subject to conditions that should, ideally, be similar to those of a traditional programme. There would be periodic revisions, to be approved by the Executive Board, but the IMF would make no kind of financial commitment. This type of instrument would basically be aimed at countries with vulnerabilities, but without an immediate balance of payments problem, so that a traditional programme would not be justified. It is argued that, in such cases, ordinary surveillance does not provide a sufficient "seal of approval" for the country's adjustment policies and that its acceptance, without receiving anything in return, of the conditions of a programme without financing would amount to a stronger signal of its commitment to sound economic policies, which might catalyse larger flows of private financing (or, in the case of low-income countries, financing from the donor community). In fact, a consensus has already been reached on the potential of these facilities without financing for such countries and a new instrument, called the Policy Support Instrument (PSI), has recently been approved. Also, these facilities could be particularly useful for IMF-financing exit strategies¹⁵.

When this type of instrument is proposed and designed, account must be taken, as already mentioned (and as the IMF itself has recognised) of the fact that the impact of the IMF's signalling has generally been less than expected¹⁶, largely because the IMF has tended to be very reluctant to issue negative signals, to avoid generating adverse market dynamics, and this has led to a loss of credibility for positive signals.

11. The G-24 has openly come out against facilities without financing (G-24 Communiqué, October 2004). **12.** The world volume of international reserves increased from USD 1.2 billion in 1995 to USD 3.8 billion in 2005. Approximately 65% of these reserves are currently held by emerging markets, compared with 38% in 1995. **13.** Since the year 2000, the participants in this initiative have been the member countries of ASEAN plus China, Japan and South Korea (ASEAN+3). **14.** Other explanations of the IMF's loss of influence in Asia are dissatisfaction with the workings of the IMF governing bodies (problems concerning the right to speak and vote) and with the IMF's response to the 1997-1998 Asian crisis. **15.** The IMF already has strengthened surveillance instruments for countries when a programme with financing expires, such as the Staff Monitoring Programme (SMP) and Post Programme Monitoring (PPM). However, the weakness of the signals issued by these instruments has led many countries to apply for subsequent programmes with financing, as their facilities have expired, so compounding the problem of prolonged use of IMF resources and, therefore, weakening their revolving character, which is one of the IMF's founding principles. **16.** See IMF (2004).

A key element in the design of facilities without financing will be the conditionality that they should incorporate. In principle, this should be equivalent to that of traditional IMF programmes, which is well known by market agents. Another more difficult to resolve question is that of the link that these facilities without financing should have to traditional programmes with financing. Were balance of payments difficulties to arise during the term of the programme without financing, it would be difficult to find arguments to deny the granting of a programme with financing, given that the country would already be complying with the terms of conditions equivalent to those of this latter type of programme.

PROPOSALS FOR INSURANCE INSTRUMENTS

The insurance proposals that have been made so far are very different, but all have some significant similarities. First, an insurance mechanism should incorporate a sufficient amount of resources to check the adverse dynamics that may be triggered by an external shock, in a context of multiple equilibria and self-confirmed expectations; given the size of the financial markets and of the potential financial crises, a mechanism of this type cannot be strictly in line with the normal limits of access to IMF resources. Second, an insurance mechanism should make the resources available to countries sufficiently rapidly (although not necessarily automatically) when the contingency covered by the insurance mechanism occurs, so that the dynamic that characterises self-confirmed crises, which is sometimes very rapid, is halted in time. Third, the volume and conditions of the financing to which an instrument of this type gives access should be known *ex ante*, to clarify the rules of the game, both for potential borrowers and for financial market participants. Fourth, and to mitigate the moral hazard problems to which this instrument may give rise, it should only be made available to those countries that apply prudent macroeconomic policies. The various proposals therefore include some component of *ex-ante* conditionality, usually articulated by means of a pre-qualification mechanism.

The most widely expounded insurance proposal and the simplest to apply would be to broaden the exceptional access policy to embrace preventive programmes¹⁷. The first condition of the exceptional access framework establishes that the normal access limits may be exceeded only by countries experiencing extraordinary balance of payments pressures. This condition precludes preventive programmes, since they are granted to meet potential balance of payments problems. That said, there are precedents for preventive programmes being granted beyond the normal access limits, as is the case of the extension made in 2003 to the Brazil programme approved in 2002¹⁸, an extension that was made by appealing to the exceptional circumstances clause.

A second type of proposal¹⁹ consists of making the normal limits for access to IMF financing a dynamic variable, determined by the past policies applied by each country. Thus, the more a country perseveres with the application of prudent macroeconomic and structural policies, the higher the level of IMF resources to which it would have access and, therefore, the higher the degree of insurance granted by the IMF. This approach has some advantages. First, it would extend to all IMF members, thereby limiting its discretionality and strengthening the predictability and universality of the scheme for crisis prevention and resolution, which is one

¹⁷. Preventive programmes are lines of financing that the IMF makes available to countries that agree not to use them unless it is strictly necessary to do so, i.e. unless a potential balance of payments problem actually arises. ¹⁸. In December 2003, the Brazilian programme originally approved in September 2002 was extended and expanded by USD 6.6 billion. The Brazilian authorities announced at the time that they did not intend to use the programme's resources, and therefore it became a preventive programme. There is broad agreement that this preventive programme enabled Brazil to make an orderly exit from its financial relationship with the IMF. This was clear in March 2005, with the announcement by the Brazilian authorities that they would not seek to renew the IMF programme that expired at that time and with the final cancellation of the programme in December 2005. ¹⁹. See Rajan (2005), and Ostry and Zettelmeyer (2005).

of the objectives of reform of the international financial architecture. Second, adequate incentives would be given, thus limiting the moral hazard problems. And, third, continuous signals would be emitted on the “quality” of a country’s policy framework, which would, in principle, reduce the negative impact on the market of discrete signals arising from the activation/deactivation of the pre-qualification for these kinds of programme, this being one of the main problems with many proposals of this type.

Finally, various proposals have been made for a specific insurance facility for emerging economies. Most of them are based on a pre-qualification mechanism, whereby only countries with solid foundations would have access. Other proposals suggest that the IMF should lend to these countries when their sovereign debt spread passes a certain threshold or that a liquidity window should be created at a pre-determined interest rate²⁰.

The key to the success of a facility of this type is its design and, in this respect, the experience of the failure of the Contingent Credit Line (CCL) is most significant. This facility was created in 1999 as a preventive instrument to counter the risk of international contagion in those emerging markets committed to the maintenance of a prudent macroeconomic policy framework and was therefore essentially an insurance instrument. However, in 2003 this facility had to be allowed to expire because no country had requested it. There were significant design failures: i) the impact that its request might have had on international financial markets was not clear. It might have been interpreted as a sign of weakness revealing the existence of vulnerabilities, and not of a greater capacity to confront them, ii) at the same time there was an exit problem, since there was concern as to the impact that loss of eligibility for the CCL might have on markets, and iii) it was not clear to what extent the access to resources was automatic, since IMF Executive Board approval was required.

The CCL entry and exit problems were closely linked to the pre-qualification mechanism that constituted the ex-ante conditionality and are, to a certain extent, inherent in any insurance instrument. One response to the stigma involved in requesting an insurance facility could be to strengthen the conditionality. The greater the extent to which the market interprets the criteria that give access to the insurance as truly demanding, the more the negative signal that might be entailed by agreeing this facility would be mitigated. That said, excessively strong conditionality could mean that only those countries with very robust fundamentals, and thus less vulnerable to a crisis, would be eligible. In fact, it is worth asking what incentives a country with such characteristics would have to submit to strong conditionality when all it would obtain in return is the coverage of a risk perceived as very remote.

One option for avoiding the CCL entry problem would be to make eligibility for the insurance facility automatic. This would mean that countries would not have to apply for the insurance, but access would instead be universal, provided the pre-qualification criteria are met. However, the impact that generous use of this facility might have on the IMF’s resources would need to be studied.

Finding a solution to the exit problems is even more complicated, because any instrument involving ex-ante conditionality generates the risk that failure to fulfil the conditions might unleash adverse market dynamics. One can think of ways to moderate the negative impact of this signal. In the case of the CCL it has been argued that the relative vagueness of the eligibility criteria gave the IMF an excessive margin for discretion and, therefore, introduced a factor

20. See Cohen and Portes (2004), and Cordella and Levy Yeyati (2005).

of uncertainty that aggravated the exit problems. In principle, if this discretionality were reduced, the market could monitor countries' eligibility for itself and the need for the IMF to issue unanticipated verdicts with destabilising effects would be eliminated. A system could be put in place, for this purpose, to determine eligibility "a la Maastricht", on the basis of the fulfilment of a set of criteria, directly observable by market agents, but not necessarily published by the IMF, summarising the ex-ante robustness of the policies applied by the countries.

Lastly, one of the lessons of the failure of the CCL is that the link between the insurance facility and access to IMF resources should be rapid and unambiguous. This means that it should be reasonably certain that, if the contingency covered by the insurance mechanism occurs, the country will have quasi-automatic access to IMF financing on the terms established ex ante. For this to be so, it is necessary that i) there be a clear, operative and observable definition of the contingencies covered by the insurance mechanism; ii) compliance with the access conditions by the countries be monitored and updated frequently (so that the time between pre-qualification and the possible activation of the financing is not excessive), and iii) rapid and relatively simple administrative procedures be put in place to effect the provision of financial assistance by the IMF.

Conclusions

There has been a fruitful debate in recent years on the IMF's role in relation to the emerging economies, which has coincided with a far-reaching strategic review of the IMF's role. The lower frequency of crises in recent years and the cancellation of the programmes of many of the countries that had suffered crises in previous years partly reflect advances in the international financial architecture, particularly in areas such as the transparency of the statistics and economic policies of these countries, the lower degree of contagion of crises and improvements in their fundamentals. However, at the same time, there is some concern that the lower recourse to the IMF may also be a consequence of the inadequacy of its instruments to protect countries from the volatility of capital flows inherent in increasingly globalised financial markets. The sharp accumulation of reserves by some of these countries would seem to reflect a certain desire for self-insurance, which would endorse this idea.

One of the possible shortcomings identified is the gap between the IMF's surveillance function and its financing function. The debate has turned on the question of whether it is better to cover this gap with a signalling instrument or with an insurance one. Signalling instruments seem suitable for low-income countries, where the available information is of poorer quality and whose financing comes from official sources. For these countries the macroeconomic conditionality of the IMF represents a guarantee of commitment with solid fundamentals. However, the usefulness of signalling instruments in the case of emerging economies, whose information has improved significantly and whose capital inflows come from private flows is more doubtful.

A priori, insurance instruments appear better suited to emerging economies, which face the risk of speculative attacks that sometimes have little or nothing to do with their fundamentals. However, designing a facility of this type comes up against complex problems, arising from the need to reconcile, on the one hand, a demanding pre-qualification mechanism providing quasi-automatic access to the IMF's resources, and on the other, a design that avoids the entry and exit problems that led to the failure of similar initiatives in the past. One solution that this article suggests might be worth considering would be the design of objective criteria (similar to the Maastricht criteria for access to Stage Three of EMU) that avoid a potentially destabilising process to establish eligibility.

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