INTERNATIONAL MONETARY FUND

Adapting Precautionary Arrangements to Crisis Prevention

Prepared by the Policy Development and Review Department

In consultation with the Finance, Legal, and other Departments

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June 11, 2003

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I. Introduction

1. **This paper explores how precautionary arrangements could be modified to better achieve some of the objectives of the CCL.**[1] During the review of Contingent Credit Lines (CCL), Executive Directors expressed support for the objectives of the CCL, but agreed that the CCL as presently constructed was unlikely to be a viable means of achieving those objectives.[2] After considering several possible modifications to the CCL, the Board agreed that the staff should explore ways to strengthen surveillance and improve existing Fund lending instruments to make them more effective in crisis prevention and to strengthen the Fund's capacity to respond quickly to the need of members with strong policies. This paper looks at how precautionary arrangements could be modified to better meet these ends. It is intended to be read alongside the proposals for modifying the CCL, as considered by the Executive Board in the March discussion on the CCL. Staff would propose to return to the broader questions of the CCL review at a subsequent meeting following the Annual Meetings.

2. **The possible modifications considered would better tailor existing precautionary arrangements for use in capital account crisis prevention.** These modifications are framed by the following objectives:

- to encourage members to adopt, early on, strong policies and reforms to lessen the probability and potential severity of a capital account crisis;
- to make precautionary arrangements more suitable to capital account crisis prevention, while maintaining adequate safeguards on the use of Fund resources; and
- to differentiate more clearly such precautionary arrangements from other Fund arrangements.

3. **The paper is organized as follows.** It first outlines how precautionary arrangements can provide a basis for strengthening the Fund's capacity to help its members prevent capital account crises; further information on the experience with precautionary arrangements is included in Appendix I. The paper then sets out a range of modifications—relating to the levels, phasing, and continuity of access—that could be made to precautionary arrangements. The following section considers some advantages and risks of this approach, followed by a discussion of alternative implementation strategies. The final section suggests issues for discussion.

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[1] Under a precautionary arrangement a member indicates to the Fund that it does not intend to make purchases. Members have expressed such intentions not to purchase in cases where the balance of payments need is potential, or when the balance of payments need is actual but the member nevertheless does not expect to draw under the arrangement.

[2] See "Review of Contingent Credit Lines" (SM/03/64, 2/12/03) and the summing up (BUFF/03/38, 3/20/03).

II. Background

4. **Increasing global integration of capital markets has heightened the vulnerabilities countries experience in their capital accounts during the process of economic development.** International capital flows can help countries to reach and sustain high levels of investment necessary to promote rapid rates of growth and economic development. However, as countries increasingly tap these market-based sources of finance, they inevitably increase their exposure to fluctuations in the availability of these sources of capital.

5. **The CCL was created in recognition of the new challenges members faced from more integrated capital markets.** It was designed to provide assurances of Fund support for countries with appropriate economic policies in the event of financial market pressures due to external events, and to reinforce incentives for strong policies. Innovative features of the CCL include (i) specific eligibility criteria, which provide a form of ex ante conditionality;[3] (ii) availability only to meet exceptional financial pressures in the capital account due to contagion; and (iii) substantial frontloading of Fund resources in the event of a shock. For members meeting the eligibility criteria, the CCL would provide a strong endorsement from the Fund of the country's policy framework, and a degree of financial insurance. However, the facility has yet to be used and further modifications do not seem to hold significant promise of overcoming the factors behind the lack of interest to date.

6. **Members have used precautionary arrangements to meet similar objectives to those of the CCL**. Precautionary arrangements also provide assurances of financial support and a clear endorsement of the member's policies, but for a larger group of countries and for a broader range of circumstances (Table 1 compares existing precautionary arrangements and the CCL).[4] With a precautionary arrangement, as intended with the CCL, members come to the Fund before significant balance of payments pressures have emerged, in support of policies that will help to reduce the likelihood or severity of future problems. Precautionary arrangements have often been used by members whose potential need is more likely to emerge in the current account of the balance of payments. However, they have also been used to address a wider range of potential balance of payments problems, including capital account pressures. In contrast to the CCL, access under precautionary arrangements tends to be low (see next paragraph) and more evenly phased over the course of the arrangement.

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[3] For resources to be committed under the CCL, eligible members have to: (i) be implementing policies unlikely to give rise to a balance of payments need; (ii) have received a positive assessment of policies at the most recent Article IV consultation; (iii) have made satisfactory progress in limiting external debt vulnerability and be maintaining constructive relations with private creditors; and (iv) have a satisfactory economic and financial program which the member stands ready to adjust as needed.

[4] Supplemental Reserve Facility (SRF) resources can be used in a precautionary context where there is an actual balance of payments need but the member decides not to draw.

Table 1. Comparison of CCL and Precautionary Arrangements

	CCL	Existing Precautionary Arrangements
Eligibility criteria for approval	Yes	No
Type of balance of payments need	Restricted to capital account shocks stemming from contagion.	No restrictions for credit tranche drawings; restricted to capital account shocks for drawing under SRF.
Access guidelines/limits	Expected to be in a range of 300-500 percent of quota.	100 percent of quota annually, 300 percent cumulatively under credit tranches. No specific limits under SRF. Exceptional access framework applies.
Phasing	Fixed tranche upon activation, remaining access phased if activation purchase is made.	First tranche available on approval; subsequent tranches made available after each test date.
Balance of payments conditions at time of approval	The member is not experiencing balance of payment difficulties stemming from contagion.	None.
Post-approval conditionality	No performance criteria. A mid-term review.	Quarterly quantitative performance criteria, structural conditionality, prior action, program reviews.
Activation review	Yes	No
Post-activation conditionality	As in any non-precautionary arrangement.	Same
Maturity (expectations/obligations basis)	1-1½ years/2 – 2½ years.	Credit tranches: 2½-4 years/3¼ - 5 years. SRF: 2-2½ years/2½ - 3 years.
Terms	Basic rate plus CCL surcharge (150-350 basis points).	Basic rate plus surcharge based on outstanding credit (100-200 basis points) and/or SRF surcharges (300-500 basis points) if applicable.
Commitment fee	25 basis points, 10 basis points for credit above 100 percent of quota.	Same

Finally, precautionary arrangements rely exclusively on traditional conditionality, such as prior actions, performance criteria and benchmarks, with no ex ante conditionality in the form of eligibility criteria, and therefore provide a different structure of incentives for good policies.[5]

7. **Access under precautionary arrangements has usually been modest.** Lower access has been justified on the grounds that the size of the potential need is expected to be small as long as the policy program is implemented. Low access also helps to provide safeguards to the Fund. If a serious balance of payments need arises, the member can request an augmentation. In this process, the Fund can help ensure that the policy response to the shock is appropriate, that it includes an adequate mix of adjustment and financing, and that the Fund's contribution to the financing is reasonable. Members using precautionary arrangements may also favor low access levels to minimize the commitment fee.

8. **Some recent precautionary arrangements have involved higher access.** The precautionary arrangements for Argentina (in 1998 and again in 2000), Brazil (2001), Colombia (1999 and 2003), and the Philippines (1998) all involved total access over 100 percent of quota cumulatively, and in Brazil's case, exceptional access (Box 1). These programs recognized that the vulnerabilities were related primarily to the capital account, and that the potential balance of payments needs were significant. They also recognized that having high access upon approval, as opposed to low access that could later be augmented, could help improve market confidence for members with capital account vulnerabilities. Half of these precautionary arrangements were drawn upon in the first year, compared with only 12 percent of more conventional precautionary arrangements.

9. **The overall experience with precautionary arrangements has been positive (see Appendix I) and, with some modifications to their structure, they could better meet some objectives of the CCL.** Precautionary arrangements are well-known and widely-used instruments. They are effective at boosting confidence in a member's policies, as evidenced by the few purchases that have been made under precautionary arrangements and the fact that many countries with precautionary arrangements have moved into a surveillance-based relationship with the Fund. However, some aspects of the structure of traditional stand-by arrangements, such as phasing, incremental increases in access, and periods when drawing rights are interruped make them of limited potential value to countries with capital account vulnerabilities. Possible modifications are discussed in the next section.

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[5] A fuller comparison of the CCL with precautionary arrangements is provided in Section IV.

Box 1. Brazil's 2001 Stand-By Arrangement

On September 14, 2001, the Board approved a 15-month stand-by arrangement for Brazil. Access was SDR 12.1 billion (400 percent of quota), with SDR 9.95 billion under the SRF and the rest in the credit tranches. The mix of credit tranche and SRF resources was set to keep annual purchases in the credit tranches within the 100 percent of quota limit. Access was phased so that SDR 3.676 billion would be available on approval. As required under the SRF, Brazil's request was based on an existing exceptional short-term financing need resulting from a weakening of market confidence related to increased uncertainty in the international environment.

Brazil's SBA/SRF arrangement was not precautionary in the usual sense that the member's balance of payments need is potential rather than actual. However, the authorities stated their intention (as noted in the staff report) not to draw unless warranted by a worsening in market conditions and external environment. The authorities considered that they could achieve a more positive market signal if they did not draw the resources made available under the arrangement, although these remained available should the need arise.

At the same time, the Brazilian authorities expressed concerns over blackout periods in their drawing rights that follow each test date, and the stigma associated with requesting a waiver, even of applicability. In the wake of September 11, 2001, with a worsening in market conditions and in the external environment, Brazil made the first purchase on September 28, 2001, just prior to the September 30, 2001 test date (in the event, all the end-September performance criteria were met). After the first purchase, and at the time of the first review, the authorities again indicated that they did not intend to make further purchases unless market conditions worsened further. In April 2002, Brazil repaid all outstanding SRF purchases, including the September 2001 purchase. However, with a subsequent worsening of market conditions, Brazil then purchased all of the SDR 7.7 billion which was available under the arrangement on June 21, 2002.

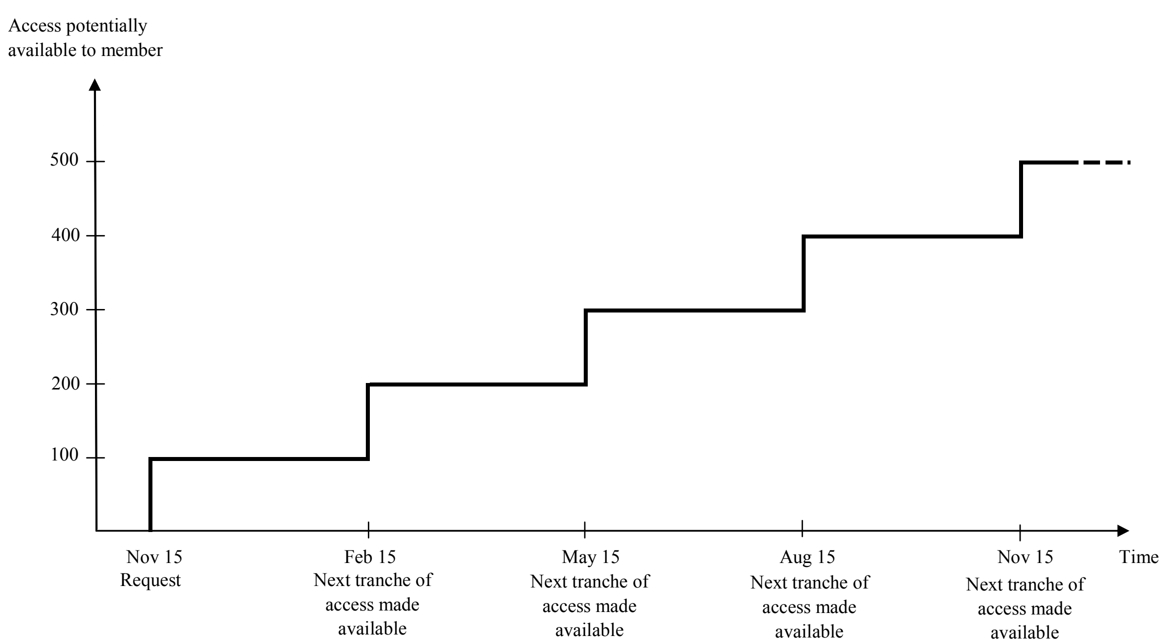
III. Design Issues and Possible Modifications

10. **This section outlines four modifications that could be considered, comprising**: (i) phasing; (ii) avoidance of interruptions to drawing rights, while maintaining adequate safeguards to the Fund; (iii) access levels when there is potential rather than actual need; and (iv) some program design issues.

Introduce a phasing pattern similar to that of the CCL

11. **The normal pattern of even phasing, with rights to purchase accumulating over the arrangement, is not well suited to countries with capital account vulnerabilities.** When an arrangement is precautionary, undrawn balances accumulate over time, all of which a member is entitled to draw as long as relevant program conditions are met and a balance of payments need arises. This creates a "staircase" pattern for drawing rights (Figure 1).[6] This pattern can result in relatively little access being available at the beginning of an arrangement, an important drawback for countries with capital account vulnerabilities where the upfront need—if it arises—is likely to be substantial. On the other hand, towards the end of an arrangement nearly the entire amount of access is available, possibly providing too much Fund support if this is the first purchase.[7]

Figure 1. The Staircase Pattern



[6] When purchases are made after each test date, the amounts available to purchase do not staircase; instead, the outstanding use of Fund credit increases. This pattern is specified in the stand-by arrangement form (see Appendix II, paragraph 2(a)).

[7] The mix between financing and adjustment that is agreed upon approval of a precautionary arrangement may no longer strike the right balance ex post, if a balance of payments need arises.

12. **Phasing more similar to that of the CCL, with the first purchase a large fixed amount, would make precautionary arrangements better suited for crisis prevention.** With this structure, upon approval of such an arrangement, the Fund would (i) commit a total amount of access under the arrangement; (ii) establish the size of the first purchase; and (iii) leave the phasing of the remaining access to be determined if and when the first purchase was made.[8] As long as the arrangement remained precautionary, the amount of the first purchase would remain fixed, and the member's right to make this purchase would be renewed after each test date. A larger first purchase would strengthen the arrangement's confidence boosting effect.

13. **The size of the first purchase would have to balance the objective of crisis prevention with that of maintaining adequate safeguards for Fund resources.** For the first purchase to provide a meaningful level of insurance (in addition to a member's reserves), it would have to be quite significant. At the same time, it should not be so large as to undermine incentives to strengthen the policy framework. Nor would it be desirable if the level of the initial purchase made it possible for the country to delay or avoid any necessary adjustment in response to a shock.[9] There is no empirical guide to determine the appropriate size of the first purchase, but a useful start could be a presumption that it would equal one third of overall access as in the CCL. In the end, however, the right balance would vary from case to case, depending on the country's individual circumstances.

Improve the balance between automaticity of drawing rights and safeguards on the use of Fund resources

14. **One of the safeguard features in the current structure of Fund stand-by arrangements results in interruptions in a member's right to make purchases (a "sawtooth pattern").** In all arrangements, rights to purchase are interrupted for a blackout period after a test date, and reinstated when all the data on performance criteria are available and show that the criteria have been met (Box 2).[10] A member wishing to draw during the

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[8] The phasing of remaining access could be done in a review similar to the CCL's post-activation review. This review would have to be completed before any additional resources were provided to the member under the arrangement. The review would reach agreement on adjustment policies in response to the balance of payments need, and on new program targets. It could be completed anytime after the first purchase was made, and upon its completion additional Fund resources could be provided if needed.

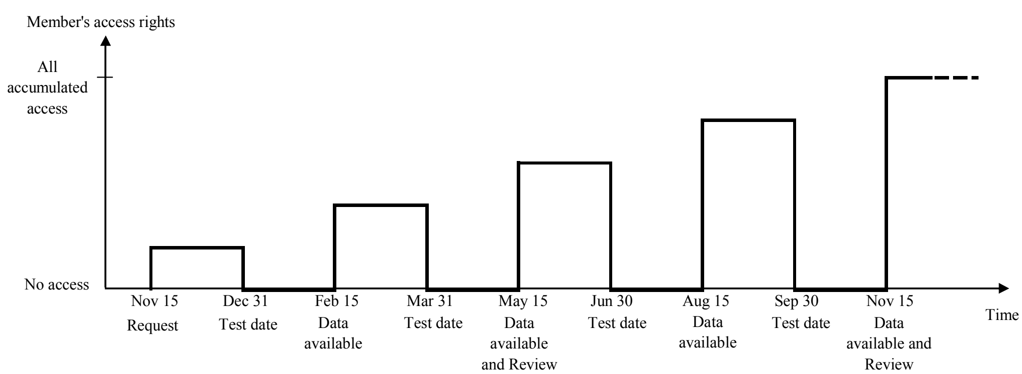
[9] The experience with capital account crises in recent years, with many countries undergoing excessive adjustments, may suggest that such delay is unlikely to be the case. For example, an IMF staff analysis concluded that the capital account crises of the 1990s "were characterized by an over-adjustment of external current accounts in relation to what was needed for any reasonable means of sustainability." A. Ghosh et al., "IMF-Supported Programs in Capital Account Crises", IMF Occasional Paper 210, 2002, p. 61.

[10] This pattern is a feature of the standard form for stand-by arrangements—see Appendix II, paragraph 3(a). Similar concerns may also apply to the timing of reviews; see Box 2.

Box 2. Waivers of Applicability and the "Sawtooth" Pattern

When a program is on-track—the performance criteria at the most recent test date have been met—a member can make a purchase of Fund resources without further Board approval until the next test date. To make a purchase between that new test date and the date at which all data for the performance criteria at that date are available, the Board must grant a waiver of applicability. This leads to recurring intervals of interrupted and reinstated rights to purchase Fund resources—a "sawtooth" pattern (see Figure 2). There is typically a lag of four to six weeks until data on performance criteria become available. Hence, in a standard 12-month arrangement drawing rights are interrupted and re-instated four times (and possibly more often depending on the timing of reviews) with the total amount of time rights are interrupted ranging between four to six months. Though waivers of applicability are requested in non-precautionary arrangements, the interruption of drawing rights less material since it usually affects only one tranche. However, they are usually requested when a review is being completed or a wavier for non-compliance requested, circumstances in which a waiver of applicability is somewhat superfluous.

Figure 2. The Sawtooth Pattern



These interruptions can be longer when reviews are scheduled. Similar to test dates, a member's right to purchase is interrupted after a scheduled review date until the date at which the Board completes the review. Reviews are often scheduled in the middle of a quarter (e.g. February 14, June 14, etc. See Appendix II, paragraph 3(d)). However, even if a program is on-track, it can be difficult to complete a review by this date (to do so, for example, may require completing negotiations on the review well before the data on performance criteria at the recent test date are known). Consequently, in such circumstances, as a result, the sawtooth pattern is exacerbated, and the periods in which a member can make a purchase without a waiver further shortened.

blackout period, which may last 4-6 weeks, must be granted a waiver of applicability by the Board. The waiver requires an assessment that the program is on track based on available information. This structure provides a safeguard to the Fund by interrupting drawing rights when data are stale, although the cutoff date is necessarily arbitrary.

15. **For a member with a precautionary arrangement, the sawtooth pattern creates uncertainty about whether drawings would be available should a need arise.** The intermittent loss of drawing rights (even if the program is on track), and the uncertainty regarding the conditions under which a waiver of applicability would be granted, lessen the assurances of the availability of the Fund's resources. It is not clear how important this problem is in practice, but it was a concern under Brazil's 2001 precautionary arrangement. Some members also believe that any request for waivers conveys a negative signal. Concerns over the interruption of drawing rights and need for waivers can create a perverse incentive to purchase before a new test date is reached, "just to be safe".

16. **A number of different approaches could be considered to avoid, or at least mitigate, the sawtooth pattern.** They all involve trade offs between making drawing rights more continuous and the strength of safeguards to the Fund. Possibilities include:

- *Extended drawing rights:* Rather than suspending drawing rights after a test date, rights could be extended to pre-established dates at which data are expected to become available. For example, suppose the program arrangement is approved on November 15 and the first test date is December 31. From November 15 the member would have the right to the first purchase under the arrangement made available on approval. Under the current structure those rights would be interrupted on December 31, the first test date for a period normally of six weeks or so. Extending the drawing rights period would delay the interruption until a later date, say February 15, the pre-agreed date at which data on the performance criteria at end-December were expected to be available. With this modification, it would be possible, in principle, for drawing rights to remain uninterrupted for an entire arrangement (provided the program remained on track). However, it would lessen safeguards by lengthening the window in which a purchase could be made on the basis of increasingly old data.[11]

- *High-frequency performance criteria*: In addition to extending access rights, a set of indicators of program performance, that are available at higher frequencies and with a shorter lag, could be established as performance criteria. A purchase would be allowed only at times when all criteria are observed. This modification would provide additional safeguards (as they would supplement standard quarterly performance criteria), and could be applied to the entire arrangement period, not just blackout

[11] Extending drawing rights would require a change from the standard form of the stand-by arrangement. For uniformity of treatment reasons, such a change might need to be applied more generally.

periods. A variant of this option would maintain the current structure of blackout periods, but make the conditions for waivers of applicability more transparent by linking them to high-frequency performance indicators which would be explicitly specified, but not set as formal performance criteria.

- *A floating activation review*: The first purchase could be made conditional on the completion of an activation review.[12] This would provide the strongest safeguards to the Fund, and the least automaticity of access for the member since a review would have to be completed to enable the first purchase at any time during an arrangement.[13] The balance between safeguards and automaticity would depend, however, on the scope of the review. The activation review might be a narrowly focused and essentially backward-looking to ensure that the balance of payments need had not arisen because the program was off-track. Alternatively, an activation review with a broader focus, including reaching understandings on the appropriate policy response to the shock, would give the member less assurance ex ante of Fund financing, but improve the safeguards to the Fund. An activation review could also provide an opportunity for a quick reassessment of the first purchase size in light of the actual balance of payments need.

Box 3 provides more detail on the advantages and disadvantages of the various options for dealing with the sawtooth pattern of drawing rights.

Access levels when the need is potential rather than actual

17. **The Fund encourages members to establish sound economic and financial policies early, as a precaution against the emergence of balance of payments difficulties.** Capital account crises can develop very quickly, sometimes leaving only a small window between the onset of pressures and a large financing need. Moreover, resolving such crises once they have developed is inherently difficult, and many past crises have involved traumatic adjustment in domestic absorption and significant financial disruption. When a country has a potential for disruptions to its capital flows, preventive measures take on an added importance.

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[12] As with the CCL, a member would have to be allowed to draw 5 to 25 percent of quota independently of the activation review, though it is unlikely that the member would draw this amount unless it needed to activate the arrangement. The precise amount available independently of the activation review would depend on the extent to which the member had already used the first credit tranche of 25 percent of quota.

[13] The review could be applied to all available resources, or just to SRF resources. A similar mechanism was considered during the discussions on the establishment of the CCL. However, this option was seen as an undesirable basis for the CCL, since the association of SRF resources with actual crises may have lessened the "first-class policy" signal of the CCL (see SM/99/54, 2/24/99).

Box 3. Balancing Automaticity and Safeguards—Pros and Cons

Alternative modifications should be assessed according to two criteria: (i) striking the right balance between automaticity of drawing rights and safeguards for Fund resources; and (ii) simplicity of implementation.

Extending drawing rights would enhance automaticity, but lessen safeguards. Implementation could be awkward. Drawing rights could, in theory, remain uninterrupted for an entire arrangement provided the program remained on track. However, there would still be an incentive to make a pre-emptive purchase to avoid the need for a waiver of non-observance. Extending drawing rights lengthens the window in which such a pre-emptive purchase could be made, and gives members considerably better information about whether or not the performance criteria were in fact met. This could increase the share of drawings by members with programs going off track. Its implementation would raise a number of issues, such as how long to extend the drawing rights, how to handle different dates of data availability for different performance criteria, etc. On the latter, since the data become available with different lags, it might be necessary to establish a series of pre-agreed availability dates that vary depending on the particular performance criterion.

High-frequency performance criteria would allow for more transparent and objective conditions for a Fund purchase. The member (and markets) would have greater assurances of the availability of Fund resources, thereby enhancing the crisis deterrence benefits to the member. Programs would still incorporate regular, less frequent, reviews to assess economic developments, program performance and program design in greater depth, and standard quarterly performance criteria.

However, high-frequency performance criteria may be difficult to implement effectively. There is a question of data availability—monetary variables such as NIR and NDA may be available for some countries at a higher frequency, but other important indicators, such as on fiscal performance, may only be useable over longer intervals. For available indicators, setting the target levels could also be difficult. If margins were large (i.e. to allow room for intervention or because of increased noise in observing variables at high frequency), Fund resources may not be adequately safeguarded. On the other hand, if margins were tight frequent breaches could lessen automaticity and, in some circumstances, unnerve markets. These conditions also would not capture delays in structural reform implementation or unexpected announcements of policy shifts. Finally, high-frequency performance criteria would not eliminate the possibility or incentives for pre-emptive purchases. This approach would impose a burden on members, limiting the flexibility in economic management that is possible under the quarterly performance criteria structure. High-frequency monitoring might also require additional staff resources.

An activation review would provide more effective safeguards, but less automaticity than other options. This lower automaticity has been seen by some observers as a shortcoming of the CCL structure, contributing to its non-use. However, basing the reviews explicitly on the observance of high-frequency indicators would make them more transparent, and would also be less cumbersome, and less difficult, than establishing the indicators as performance criteria. Some non-quantitative indicators of performance could also be captured, though the scope of the reviews could be made explicitly more limited than regular reviews in order to preserve assurances to the member. Pre-emptive purchases would not be possible.

18. **However, for countries with open capital markets, the structure of current lending policies tilts incentives towards waiting until an actual balance of payments need has materialized.** The normal practice of providing lower access levels in precautionary arrangements may encourage members who are vulnerable to capital account pressures to wait until they have an actual balance of payments need before seeking a Fund arrangement. The stigma that some associate with a Fund arrangement is no doubt another disincentive. Also, commitment fees, which members pay under all arrangements but which are refunded as purchases are made, are a third, if lesser, concern. Such factors may tilt incentives amongst the membership to come to the Fund too late, when the need is more acute and the potential to avert a larger crisis is much diminished.

19. **Providing front-loaded access above normal limits is an integral part of the CCL.** As countries have become more integrated in global capital markets their potential balance of payments needs have become higher. To provide meaningful incentives to these members to take preventive steps to reduce capital account vulnerabilities, and to have an impact on market confidence in circumstances where capital flows are significant, a crisis prevention facility such as the CCL has to be able to offer flexibility above normal access limits. For precautionary arrangements, the flexibility to go above the normal access limits provides similar advantages, although that flexibility would have to be carefully constrained. Clarifying the Fund's readiness to do so, and the circumstances in which it would be appropriate, would enhance the attractiveness of precautionary arrangements as a vehicle of support for preventive reforms. Under the CCL, access was expected to be in the range of 300-500 percent of quota, and this seems reasonable also as an upper range for precautionary arrangements, if not an absolute limit.

20. **General Fund lending policies provide a degree of confidence that precautionary arrangements would be used only in circumstances when they are very likely to be effective in preventing or mitigating capital account pressures.** In particular, the strength of the member's policy framework, and thus its capacity to repay the Fund, is a fundamental part of access decisions. Upper credit tranche conditionality provides an additional safeguard that Fund resources are used as intended.

21. **The recently adopted new criteria and procedures for exceptional access would also apply to precautionary arrangements.**[14] The new procedural elements of the framework would ensure the Executive Board is consulted at an early stage in program

[14] Exceptional access includes access under any facility or policy that exceeds the limits applying to credit tranche resources. The four exceptional access criteria are: (i) the member experiences exceptional balance of payments pressures in the capital account; (ii) a rigorous and systematic analysis that indicates that there is a high probability that the debt will remain sustainable; (iii) the member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding; and (iv) the policy program of the member country provides a reasonably strong prospect of success, based in part on an assessment of the government's institutional and political capacity to implement that program. See Summing Up by the Acting Chair, "Access Policy in Capital Account Crisis" (BUFF/02/159, 9/20/02).

discussions. The exceptional access criteria, particularly the emphasis on a robust assessment of sustainability and the capacity of the member to put in place a sufficiently strong policy framework, apply equally, in principle, in a precautionary setting. There would have to be some differences in application, however. The first criterion—the existence of an exceptional balance of payments need—would have to be modified or interpreted to incorporate circumstances where the need for access above normal limits is potential or prospective, rather than actual.[15] The identification of such circumstances would necessarily involve judgment, both on the likelihood of an exceptional need and, if the member is already experiencing some balance of payments pressures, on whether a prospective arrangement should be precautionary or non-precautionary. The criterion on prospects for regaining market access, in a precautionary context where a member is still able to borrow externally and domestically, would need to be applied only prospectively at approval.

Tailoring programs to a member's circumstances and existing policy strengths

22. **For those members whose existing policy frameworks are sufficiently strong, approval of a precautionary arrangement may not require additional adjustment beyond their existing policy baseline.**[16] Precautionary arrangements with substantial access would only support member countries with suitably strong policies that, consistent with existing policies on access and conditionality, give confidence about the member's capacity to repay (i.e. ensuring external viability) should drawings be made. As in all arrangements, adjustment programs supported by these precautionary arrangements would be tailored to the individual circumstances influencing the member's capacity to repay. Members with strong policies already in place, would not necessarily have to undertake additional adjustment, as long as the exceptional access criteria are met, as well as the general standards of upper credit tranche conditionality. Members in different circumstances might need to build more adjustment into the policy baseline or provide more confidence regarding how the necessary policy path would be achieved. Meeting these standards is necessary not only to ensure adequate safeguards for Fund resources, but also to preserve the strength of the signal provided by a precautionary arrangement of the Fund's endorsement of a member's policies.

[15] Consideration could be given to applying the exceptional access criteria to precautionary arrangements where access is within normal limits, but there is the potential for access to exceed the normal limits. For example, in a precautionary arrangement such as Colombia (2003), where total and annual access levels were within normal access limits, the phasing allows actual purchases to exceed 100 percent of quota (in 12 months) if the arrangement turned non-precautionary.

[16] This refers only to policies when there is no actual balance of payments need. All members would have to adjust policies if a significant balance of payments need emerged during the precautionary arrangement.

IV. PRECAUTIONARY ARRANGEMENTS IN CONTEXT

Comparison with the CCL

23. **The structure of precautionary arrangements could avoid some of the key factors which limited interest in the CCL, such as the entry and exit problems, many of which were linked to the CCL's prequalification approach.**[17] Precautionary arrangements are potentially available and likely to be more attractive to a broader range of countries. Nevertheless, as with the CCL, stigma may still deter some members from entering such arrangements, and perhaps more so for those members with the strongest policies. Using precautionary arrangements to support a member's implementation of preventive measures has a number of strengths:

- Precautionary arrangements can provide incentives for the early adoption of strong policies, without the broader complications of a pre-qualification regime based on eligibility criteria.

- Precautionary arrangements can help reduce vulnerabilities by providing countries with a means of temporarily supporting market confidence during the period in which reforms are undertaken, but this financial support is granted in a framework of conditionality. This constitutes a specific framework for assessing whether policy implementation remains on-track, and thereby sends a clearer signal to the financial markets and establishes a stronger set of safeguards for the Fund.

- The structure of conditionality in precautionary arrangements is more transparent, and this could help reduce uncertainty about the availability of resources in the event of need. The options discussed earlier would lessen the interruption in drawing rights by extending this transparency throughout blackout periods.

- The "entry" and "exit" problems associated with the CCL are less significant for precautionary arrangements, or at least different.[18] Exits from successfully completed precautionary arrangements have not been associated with material market reactions. There would still presumably be some deterrent (stigma) to entry into a precautionary arrangement, as with other Fund arrangements.

- Precautionary arrangements enhance the Fund's capacity to respond quickly and flexibly should a balance of payments need arise. With an arrangement already in

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[17] See "Review of Contingent Credit Lines" (SM/03/64, 2/12/03) for a discussion of these factors.

[18] Under the current structure, non-renewal of a CCL by an eligible member could happen because the member is no longer interested in a CCL, or it could be the result of a loss of eligibility. This ambiguity creates the potential for exit to send an adverse signal to markets.

place there is greater clarity on the conditions of the Fund's involvement, and a closer policy dialogue with the authorities.

Considerations and potential risks

24. **Use of precautionary arrangements in capital account crisis prevention carries some risks.** In general, however, these risks seem limited in comparison to the available alternatives, and they can be mitigated:

- As with any Fund arrangement, the commitment of resources under precautionary arrangements entails financial risks to the Fund. Such risks increase as exposure is higher. In contrast to the CCL, precautionary arrangements rely on a traditional structure of conditionality to help mitigate these risks. Since precautionary arrangements support policy implementation ahead of financial pressures, they can play a potentially important role in reducing the incidence of crisis and the ultimate need for Fund resources.

- There may be pressures to use precautionary arrangements—including with higher access—in situations when other forms of engagement with the country would be preferable. For example, ready access to Fund resources could sometimes reduce the incentive to make the necessary policy adjustments. In such circumstances, precautionary arrangements with higher access could add to the usual risks to Fund resources, undermine the credibility of the instrument, or weaken incentives for members to adopt appropriately strong policies (moral hazard). Ultimately, as with all arrangements, the best safeguard against these risks is to ensure that such arrangements are used selectively and only in support of strong policy frameworks. Careful application of the exceptional access criteria, together with the procedures for early Board involvement, would be crucial to this end.

- Finally, there may be a concern that after an arrangement is approved a member could draw the first purchase in circumstances where it is financially attractive to do so relative to alternative private sources of finance—that is when it is convenient rather than necessary. Conditionality can help to mitigate this risk somewhat, and members may hesitate to make a purchase that would signal a deterioration in their balance of payments. This is also an argument for using the SRF with its higher charges in precautionary arrangements with exceptional access.[19]

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[19] A member drawing from the Fund must represent that it has a balance of payments need. This representation can, in principle, be challenged ex post by the Fund, potentially leading to an early repurchase, but this has never been done. However, when SRF resources are used there is the additional requirement that the member represent that its balance of payments need was of the type for which SRF resources are available.

V. IMPLEMENTATION ISSUES

25. **The options outlined above could be implemented in several ways; most could be implemented under existing Fund policies.** Under current Fund policies, high access and SRF resources have been used in a setting that was essentially precautionary, and the new exceptional access criteria would automatically apply if access were exceptional. High-frequency indicators or performance criteria could be added to these arrangements. Staff guidance could be issued to clarify considerations on the use of precautionary arrangements in capital account cases, on designing programs for such precautionary arrangements which appropriately reflect the strengths of the member's existing policies and policy frameworks, and on the application of the exceptional access criteria to precautionary settings. Additional features such as CCL-like phasing, or an activation review, could not be implemented under existing policies as they require changes to the standard stand-by arrangement.

26. **A broader set of proposals could be adopted as a package of measures with a new policy on precautionary arrangements for capital account cases.** It would include a modification of the SRF so that its resources could also be committed to members in precautionary settings with a potential balance of payments need.[20] This would provide a clearer basis for use of SRF resources in precautionary settings than does the current policy under which SRF resources can be committed only in the "precautionary" setting where members face an actual balance of payments need, but nevertheless state their intention not to draw unless conditions deteriorate. This would be accompanied by guidance on the use of precautionary SRFs, appropriate guidance on program design, and the adoption of the exceptional access criteria in precautionary settings. It would also include the adoption of a CCL-like phasing pattern, and could include an activation review if desired. These changes would require new clauses for stand-by arrangements. Rather than change the standard form for all stand-by arrangements, these new clauses could be added to the forms in specific precautionary circumstances. Use of these clauses would be guided by the overall policy on the use of these precautionary arrangements as outlined above.[21]

27. **Staff see merit in considering a package of changes, as a way of defining a general policy on precautionary arrangements for members subject to capital account vulnerabilities.** The modifications themselves would help to better tailor precautionary

[20] The Board decision would require only a simple majority of the votes cast. A member that subsequently made an SRF purchase under a precautionary arrangement would still be required to represent that it had a balance of payments need of the type for which SRF resources are available; that is, "...balance of payments difficulties due to a large short-term financing need resulting from a sudden disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves." Decision No.11627-(97/123). The SRF decision does not require the member's representation of its need to be assessed in accordance with the SRF decision prior to the member making a purchase.

[21] The new clauses and accompanying policy on use would require a simple Board majority.

arrangements to capital account cases, and together with the policy clarifications, to better differentiate this type of precautionary arrangement from other forms of Fund lending. Adopting the policies as a package, under the rubric of a general policy on precautionary arrangements for members subject to capital account vulnerabilities, would help to reinforce these benefits. In the same vein, consideration could also be given to a new name for this type of approach, with the objective of lessening the stigma some members may associate with Fund arrangements more generally.[22]

28. **A modified policy on precautionary arrangements would have some implications for Fund liquidity.** The ability of the Fund to provide the resources committed under precautionary arrangements would have to be beyond doubt, both for the credibility of the Fund and for the arrangement to have a confidence-boosting impact on markets. While in some respects the liquidity implications might be similar to those the Fund is already prepared for under the CCL, it is possible that such precautionary arrangements would be used by a broader range of the membership.[23] This may lead to a larger commitment of Fund resources on a precautionary basis, and possibly greater use. On the other hand, having such precautionary arrangements in place could help reduce the likelihood and size of potential balance of payments needs. This could imply that a higher level of Fund resources committed under precautionary arrangements may not lead to higher amounts of Fund resources actually drawn. A further liquidity issue is whether high level of commitments under precautionary arrangements could constrain the Fund in its response to a system-wide crisis should those resources be called upon, or if other members (without arrangements) were to request Fund resources. These issues could be considered further in light of the Board discussion on the current paper.

VI. Issues for Discussion

29. **The Fund's encouragement of sound economic and financial policies is particularly important for members with capital account vulnerabilities.** The severity and speed of capital account crises make them inherently difficult to resolve once they have begun. Hence, preventive measures to lessen vulnerabilities, and thereby reduce the likelihood and potential severity of a crisis, take on an added importance. While surveillance can help encourage strong policies, for some members appropriate preventive lending policies can provide additional incentives. However, the expiry of the CCL could reinforce existing incentives for countries to come to the Fund too late, when the need is more acute and the potential to avert a larger crisis is much diminished.

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[22] Such precautionary arrangements would be provided under a stand-by arrangement, as is the CCL. Renaming the underlying arrangement, by contrast, would have the disadvantage of precluding use of the New and General Arrangements to Borrow (NAB and GAB).

[23] Under the forward commitment capacity methodology, resources committed under precautionary arrangements are scored at 100 percent, equivalent to the treatment of resources committed under CCLs or non-precautionary arrangements.

30. **Precautionary arrangements have long been used to support members with balance of payments vulnerabilities, but without an immediate financing need.** Similar to the CCL, precautionary arrangements provide assurances of financial support and incentives for sound policies, but for a larger group of countries and for a broader range of circumstances. However, some aspects of the traditional stand-by arrangements, such as phasing and blackout periods in drawing rights, become problematic in a precautionary setting for countries with capital account vulnerabilities. Thus, while the overall experience with precautionary arrangements has been positive, with some modifications they could better meet the needs of member countries with capital account vulnerabilities, and better meet the objectives of the CCL. To this end, this paper has presented a number of modification options for consideration, related to phasing, drawing rights, access, and program design.

31. **Directors may wish to comment on the following questions.**

On the broader issues:

- Overall, do Directors see merit in the possible modifications as a means of better adapting precautionary arrangements to crisis prevention?

- Do Directors see modified precautionary arrangements as a workable means to meet some of the objectives of the CCL?

Turning to the possible modifications:

- On phasing under precautionary arrangements, the normal pattern of even phasing creates a staircase pattern with too little available at the beginning of the arrangement for countries with capital account vulnerabilities. Do Directors agree that phasing more similar to that of the CCL (with a larger, floating first purchase) would make precautionary arrangements better suited for crisis prevention?

- On drawing right interruptions, in stand-by arrangements, a member's right to make a purchase follows a sawtooth pattern: rights are interrupted after a test date and reinstated only when all the data on performance criteria are available to show that the criteria have been met. This paper has presented three approaches to avoid the sawtooth pattern for drawing rights: (i) *extending the period of drawing rights* to pre-established dates at which data are expected to become available; (ii) using *high-frequency performance criteria* and allow a purchase to be made only at times when all criteria are being observed (alternatively, the current structure of blackout periods could be maintained, but the approval of waivers of applicability could be linked to the observance of high-frequency performance indicators); and (iii) a *floating activation review* would have to be completed for the first purchase to be made. Directors may wish to comment on how they see the relative merits of these approaches, in particular on their implications for the safeguards to the Fund and the member's assurances of availability of financing.

- The paper has set out some advantages of higher access as a means to provide precautionary support for countries implementing strong policies before the onset of a crisis, and potentially helping to present such a crisis. How do Directors view the balance of advantages and risks to such an approach?

- Like all Fund programs, precautionary arrangements with high access should only support member countries with policies that are sufficiently strong to give confidence about the member's capacity to repay should drawings be made. For members with strong policies already in place, existing program design standards would allow these members to enter a precautionary arrangement without having to undertake further adjustment effort. Do Directors agree that it could be beneficial to more explicitly recognize this possibility in Fund programs?

- Do Directors see merit in considering possible changes to precautionary arrangements together as a package, involving the above-discussed pattern for phasing, more continuous access to the first purchase, and availability of higher access? In the same vein, do Directors consider that a separate name for this new approach could be useful to lessen the stigma some members may associate with Fund arrangements more generally?

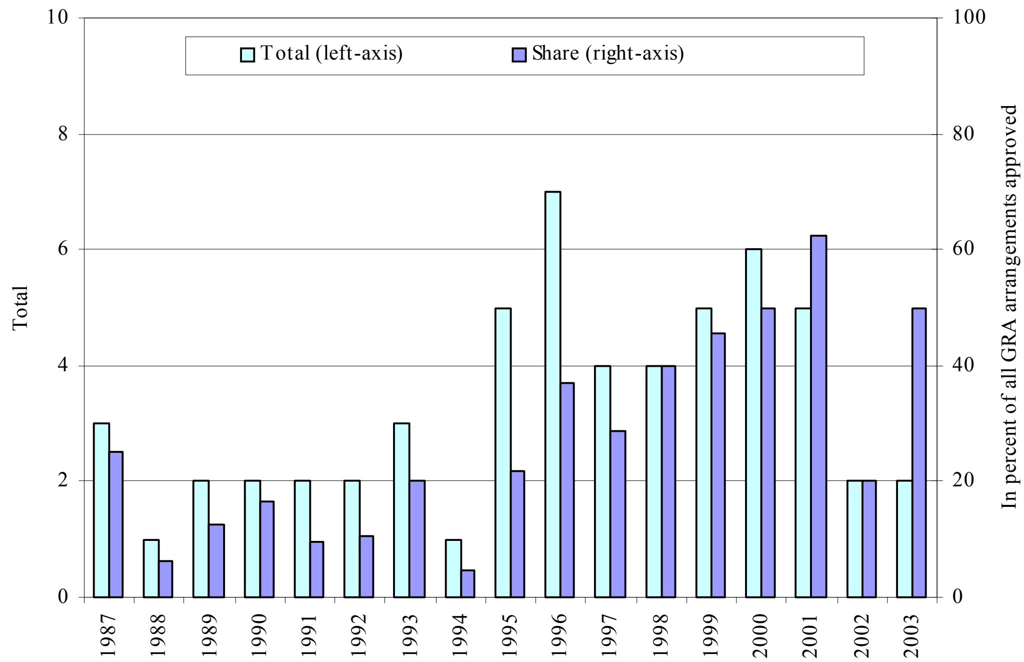
Next steps

32. If there is interest among Executive Directors, staff could follow up with specific proposals elaborating the options in this paper. In addition, based on guidance from this discussion, staff would propose to return to the broader questions raised in the CCL review at a subsequent meeting.

The Experience with Precautionary Arrangements

1. **The Fund has a long tradition of using precautionary arrangements to support members facing balance of payments vulnerabilities, but without immediate financing need.** Precautionary arrangements have always been part of the Fund's toolkit; indeed, the precautionary element is embodied in the idea of a "stand-by".[24] During 1987-2003 (through April), a total of 56 precautionary arrangements were approved (for 23 members), representing one-quarter of all stand-by or extended arrangements (EFFs) approved in that period. Precautionary arrangements have become increasingly used since the mid-1990s; 40 percent of all stand-by arrangements and EFFs approved since 1995 have been precautionary compared with an average of 20 percent during 1987-94 (see Figure 1) .[25]

Figure 1. Precautionary Arrangements Approved



Source: Executive Board documents.

[24] Executive Board Decision No. 102-(52/11) of February 13, 1952 states: "Sometimes a member may want to submit to the Fund a specific request for drawings, ... At other times discussions between the member and the Fund may cover its general position, not with a view to any immediate drawing, but in order to ensure that it would be able to draw if, within a period of say 6 to 12 months, the need presented itself." See *Selected Decisions*, December 31, 2001, pp. 149-150.

[25] These are arrangements where, at the time of approval; the authorities indicated their intentions not to draw. In addition, there are cases where, after having made purchases under the arrangement, the authorities decided to start treating it as precautionary (for example, Korea (1997) and Thailand (1997)).

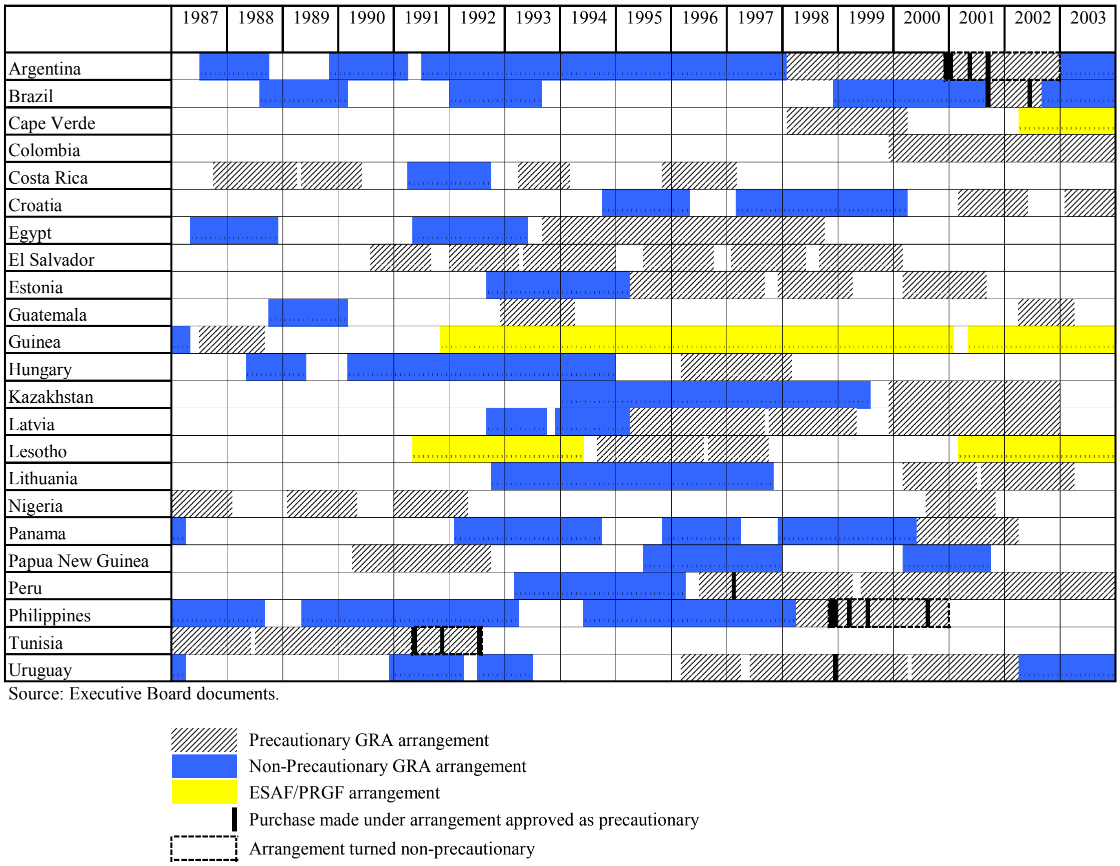
2. **Precautionary arrangements help reinforce incentives for strong policies, while providing assurances of financing in the event a balance of payments need arises.** The circumstances for the 23 members that requested precautionary arrangements during 1987-2003 vary considerably, but a commonality is that the precautionary arrangement helped provide macroeconomic discipline, boost confidence in economic policies and help mobilize external assistance. Several countries (e.g., Costa Rica, Croatia, Egypt, Estonia, Hungary, Latvia, Lithuania, Panama, and Peru) requested precautionary arrangements after one or more conventional Fund-supported programs, suggesting that the conventional arrangements were successful in eliminating the balance of payments need, but some vulnerability remained. Hungary, and the three Baltic States, for example, later moved into a surveillance-based relationship with the Fund.

3. **Precautionary arrangements can help reduce external vulnerability.** A precautionary arrangement provides a member with a clear endorsement from the Fund of its economic policies, and this endorsement, underpinned by the Fund's willingness to support the program with its own resources, helps boost confidence in the member's economic policies. The improved confidence in turn reduces external vulnerability. The assurance of financing if a need arises also improves confidence and reduces vulnerability.

4. **The experience with precautionary arrangements has generally been positive.** One sign of the effectiveness of precautionary arrangements is that in only seven of the 56 cases did members actually make a purchase.[26] Another sign of their effectiveness is that, as mentioned, many countries, after one or more precautionary arrangements, moved to Fund surveillance only (Figure 2). Out of the 23 countries that used precautionary arrangements sometime during 1987-2003, 14 (or 60 percent) no longer have any type of Fund arrangement, three have precautionary arrangements, three have regular upper credit tranche arrangements, and three have PRGF arrangements. The general effectiveness of precautionary arrangements is also suggested by their increased use among members. Box 1 summarizes Estonia's successful experience with precautionary stand-by arrangements.

[26] In addition, 17 arrangements were interrupted at least once and the member country was not allowed to draw.

Figure 2. Members with Precautionary Arrangements Approved, 1987-April 2003



Source: Executive Board documents.

5. **The Board has also recognized the effectiveness of precautionary arrangements**. The Summing Up of the 1995 Board discussion of precautionary arrangements, enhanced surveillance, and program monitoring, states:[27]

> *Directors felt that precautionary arrangements had been a useful instrument—in the spirit of the classic stand-by arrangements—to signal the Fund's endorsement of a member's policy. Such arrangements helped to foster close collaboration between the Fund and the member in a program mode, even in the absence of an immediate balance of payments need, and had, in some instances, helped boost the confidence of the international or domestic financial community in the member's policies, thus helping to ensure that a balance of payments need did not arise. Finally, they had provided members with a supplement to their reserves should a balance of payments need arise during the period of the arrangement.*

[27] Summing Up by the Chairman "Precautionary Arrangements, Enhanced Surveillance, and Program Monitoring; and Need as a Condition for the Use of Fund Resources", January 9, 1995.

Box 1. An Example: Estonia's Experience with Precautionary Stand-By Arrangements

Estonia had four precautionary stand-by arrangements in 1995-2000, following two conventional stand-by arrangements in 1992-95. The authorities have indicated that the precautionary SBAs were very useful in providing incentives to follow strong policies (including in structural areas). The authorities have also indicated that the explicit Fund endorsement entailed by the precautionary arrangement helped signal credibility of their policies, in both domestic and external contexts. The precautionary arrangement was helpful when Estonia experienced contagion in 1997-98 and adherence to the program became a condition for bilateral support from neighboring central banks. The Estonian authorities also felt confident that high access was available through an augmentation or SRF if needed.

6. **Part of the strength of precautionary arrangements comes from the fact that they are subject to the same standards as conventional stand-by arrangements.** Indeed, a precautionary arrangement *is* a conventional stand-by arrangement, but with the member (typically) expressing its intention not to make purchases at the beginning or during the period of the arrangement.[28] Precautionary arrangements are therefore subject to the same standards as conventional arrangements regarding policy objectives (e.g., medium-term balance of payments viability), and the same requirements with respect to conditionality, and monitoring procedures. These standards and requirements are crucial for the confidence-bolstering quality of the precautionary arrangement.

7. **Precautionary arrangements are subject to the regular access policy, but access levels have tended to be modest and almost always lower than under non-precautionary arrangements.**[29] During 1987-2003, the average annualized access in precautionary arrangements was 40 percent (median 31 percent), compared with 61 percent for non-

[28] Until recently, precautionary EFFs were not uncommon. In 2000, at the time of the Review of Fund Facilities, the Board agreed that extended arrangements should generally not be formulated on a precautionary basis, as circumstances where potential balance of payments difficulties were likely to turn out to be longer-term are probably very rare. See Summing Up by the Acting Chairman "Review of Fund Facilities—Proposed Decisions and Implementation Guidelines", November 17, 2000.

[29] Decisions on access are based on the member's balance of payments need (potential need for precautionary arrangements) and the strength of its policy adjustment. See "Need as a Condition for the Use of Fund Resources" (SM/94/299; 12/16/94). Precautionary arrangements are subject to the regular access limits, namely that gross purchases should not exceed 100 percent of a member's quota in any 12-month period, and outstanding purchases should not exceed 300 percent of quota.

precautionary arrangements (median 46 percent) (see Figure 3).[30] Lower access has been appropriate because the authorities' policies have produced relatively small prospective financing requirements on approval. The catalytic effect of the Fund arrangement was viewed as sufficient. Also, since the size of the potential need is unknown, there is generally no need to presume that it would be large so long as the policy program is implemented and no major changes occur in the external environment.[31] Members may also favor low access under precautionary arrangements to avoid paying large commitment fees. [32] If an external shock materializes, the member could request an augmentation under the arrangement. Of course, to provide adequate safeguards to the Fund, the mix of financing (and the Fund's share in it) and adjustment to a large adverse shock would need to be adequate.[33]

8. **Precautionary arrangements may be requested for any type of (potential) balance of payments problem, whether it relates to the current or the capital account.** The member typically does not specify how and where the balance of payments need is most likely to arise. Clearly, in many countries, the main source of vulnerability relates to the capital account. The usefulness of precautionary arrangements in dealing with capital account vulnerability was recognized in the 1995 Board discussion and the above-reference to *the confidence of the international and domestic financial community* in the Summing Up.

[30] The average access for non-precautionary was 47 percent if SRFs and exceptional access cases are excluded. The tendency for lower access in precautionary arrangements, when controlling for other factors, was also found in the econometric study in "Review of Access Policy in the Credit Tranches and Under the Extended Fund Facility—Background Paper" (EBS/01/134; 8/10/01). The lower bound for access is often 30 percent of quota for precautionary arrangements, owing to the availability of the first credit tranche.

[31] For example, see "Review of Access Policy in the Credit Tranches and Under the Extended Fund Facility" (EBS/01/13; 8/9/01).

[32] Commitment fees, which members have to pay under a precautionary arrangement but which are returned if the arrangement turns non-precautionary, are another disincentive to use precautionary arrangements, and even more so if access is high. Commitment fees are 25 basis points of the amount committed up to 100 percent of quota, and 10 basis points on the amount committed above 100 percent of quota.

[33] In a non-precautionary arrangement, a shock that increases the balance of payments need cannot be financed from (additional) Fund resources unless the member presents a case for augmentation, and the Fund will typically insist on some adjustment. By contrast, in a precautionary arrangement, Fund resources by definition go to finance unforeseen shocks, and low access ensures that only small shocks can be entirely financed. If a serious balance of payments need arises, the member can always request an augmentation, which allows the Fund to ensure that the policy response to the shock is appropriate, that it includes an adequate mix of adjustment and financing, and that the Fund's contribution to the external financing is reasonable.

Figure 3. Average Annual Access in Precautionary Arrangements

Source: Executive Board documents.

9. **Recently, precautionary arrangements involving relatively higher access have been approved specifically to deal with capital account vulnerabilities.** The precautionary arrangements for Argentina (in 1998 and again in 2000), Brazil (2001), Colombia (1999 and 2003), and the Philippines (1998) (Table 1) all involved total access over 100 percent of quota: the Brazil 2001 arrangement involved exceptional access on approval.[34] In five cases, annual access was even above the average for non-precautionary arrangements. The potential for capital account pressures was used as justification for the high access, and an objective of each program, and part of the rationale behind high access, was to boost market confidence. Brazil's stand-by was 15-months long, while the others were multi-year arrangements (including three EFFs).

[34] With access above 100 percent of quota, purchases can exceed the access limits if the arrangement becomes non-precautionary toward the end.

Table 1. Precautionary Arrangements with High Access, 1987-April 2003
(Amounts in percent of quota applicable at approval of arrangement)

Member	Approval Date	Planned Duration (In months)	Arr. Type	Access at approval		GFN 1/	First Purchase	
				Total	Average Annual		Date	Amount
Argentina	2/4/1998	36	EFF	135	45	4	...	...
Philippines	4/1/1998	24	SBA	161	81	16	11/4/1998	31
Colombia	12/20/1999	36	EFF	253	84	10	...	...
Argentina	3/10/2000	36	SBA	255	85	7	12/21/2000	75
Brazil	9/14/2001	15	SBA	400	320	19	9/28/2001	121
Colombia	1/15/2003	24	SBA	200	100	15	...	...

Source: Executive Board documents.

1/ Gross Fund Financing/Gross Financing Requirement; GFF includes all use of Fund resources during the period under the arrangement and associated purchases that were anticipated at the time of approval. GFR is defined as the sum of the current account deficit (excluding grants), amortization of maturities in excess of one year including Fund repurchases, the targeted reduction in arrears (in cash as well as through rescheduling) and the targeted buildup in gross reserves. Figures may be estimated based on information available for the period most closely corresponding to the program period.

10. **In three of these six precautionary arrangements the member made a purchase** (Argentina 2000; Brazil 2001; and the Philippines 1998). In each case, the first purchase was made during the first year of the arrangement. This record stands in contrast to the general experience with precautionary arrangements where very few countries actually make purchases: purchases were made in only 4 out of 50 more traditional precautionary arrangements.

EXAMPLE OF STAND-BY ARRANGEMENT
(Paragraphs 1- 4)

Attached hereto is a letter from the Minister of Public Finance and the Governor of the National Bank of [Country] (the "Letter"), with an attached Memorandum on Economic and Financial Policies of the Government of [Country] (the "Memorandum") and Technical Memorandum of Understanding ("TMU"), requesting a stand-by arrangement from the International Monetary Fund and setting forth:

(a) the objectives and policies that the authorities of [Country] intend to pursue for the period of this stand-by arrangement; and

(b) understandings of [Country] with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of [Country] will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of eighteen months from November 15, 2001 [Country] will have the right to make purchases from the Fund in an amount equivalent to SDR 700 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 100 million until February 15, 2002, the equivalent of SDR 200 million until May 15, 2002, the equivalent of SDR 300 million until August 15, 2002, the equivalent of SDR 400 million until November 15, 2002, the equivalent of SDR 500 million until February 15, 2003, and the equivalent of SDR 600 million until April 15, 2003.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of [Country]'s currency subject to repurchase beyond 25 percent of quota.

3. [Country] will not make purchases under this stand-by arrangement that would increase the Fund's holdings of [Country]'s currency subject to repurchase beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the ceiling on average net domestic assets of the National Bank of [Country], or

(ii) the floor on net international reserves of the National Bank of [Country], or

(iii) the ceiling on the deficit of the general government, or

(iv) etc.

specified in Table 1 of the Memorandum and in the TMU is not observed; or

(b) if, at any time during the period of the stand-by arrangement, the general government accumulates any new external payments arrears as specified in Table 1, Annex A of the Memorandum and in the TMU, or

(c) after May 14, 2002, November 14, 2002, and April 14, 2003 until the reviews contemplated in the second paragraph of the Letter have been completed; or

(d) if, at any time during the period of the stand-by arrangement, [Country]

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements that are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When [Country] is prevented from purchasing under this stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and [Country] and understandings have been reached regarding the circumstances in which such purchases can be resumed.