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## IMF POLICY PAPER

### REVIEW OF FLEXIBLE CREDIT LINE, THE PRECAUTIONARY AND LIQUIDITY LINE, AND THE RAPID FINANCING INSTRUMENT

January 27, 2014

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- The **Staff Report** on The Review of the Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument, prepared by IMF staff and completed on January 27, 2014 for the Executive Board's consideration on February 14, 2014.
- **Staff Supplement** on The Review of the Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument.
- A **Press Release** summarizing the views of the Executive Board as expressed during its February 14, 2014 consideration of the staff report.

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**Washington, D.C.**



## REVIEW OF THE FLEXIBLE CREDIT LINE, THE PRECAUTIONARY AND LIQUIDITY LINE, AND THE RAPID FINANCING INSTRUMENT

January 27, 2014

### EXECUTIVE SUMMARY

**This review of the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL), and the Rapid Financing Instrument (RFI) focuses on four key issues:** (i) the demand for the FCL and PLL in the context of the broader role of the Fund's lending (including precautionary) instruments in the global financial safety net (GFSN); (ii) the qualification/conditionality framework for the FCL and the PLL; (iii) concerns about repeated usage of FCL arrangements by the same members and consideration of ways to further improve the transparency in the discussion of access/exit in the underlying staff documents; and (iv) the lack of demand for the RFI. The paper argues:

- **GFSN.** The Fund has a central role in the network of crisis prevention and mitigation instruments within the GFSN. The FCL/PLL are important tools for crisis prevention and resolution. However, despite recent episodes of stress in emerging markets, demand for the FCL/PLL has been relatively modest. Country surveys suggest that political stigma related to the Fund remains an important ongoing factor, and the review paper proposes some ways forward.
- **FCL/PLL—Qualification/Conditionality Framework.** Experience to date suggests a general difficulty in identifying members that have “sound” fundamentals and policy frameworks, and track records of implementing such policies, while also having some remaining vulnerabilities. In addition, a membership survey points to countries’ desire for more transparency and predictability in qualification. Accordingly, the paper proposes to: (i) unify the qualification areas for the FCL and the PLL (without making any change to the qualification standards of either instrument, i.e., “very strong” for the FCL and “sound” for the PLL); and (ii) develop and use selected indicators of institutional strength to complement the existing quantitative indicators for qualification for the FCL and the PLL. These indicators of institutional strength would further help inform the judgments underpinning qualification assessments. The paper also notes the scope for greater use of ex post conditionality in PLL arrangements where remaining vulnerabilities are acute. Notwithstanding difficulties in PLL qualification assessments, the paper proposes maintaining the instrument (including the PLL arrangement of six-month duration) for now, and reassessing whether it should be retained in the Fund’s toolkit at the time of the next review.
- **FCL/PLL—Access and Exit.** The discussion of access in FCL arrangements have generally been more thorough and transparent in staff reports since the 2011 review of the FCL and PCL, and there is no compelling evidence of undue repeated use of the FCL. However, given concerns about the assessment of external risks, and the important link between external risks and access, the paper proposes to develop a new indicator to track the evolution of external stress and support the broader consideration of external risk. Nevertheless, judgment will maintain a central role in the assessment of external risks. Given concerns about timely exit, the paper considers options for introducing price-based incentives (i.e., modified commitment fee structure) to support timely exit.
- **RFI.** The RFI has not seen any use, with internal interviews pointing to the low level of possible access as a primary reason. In addition, some senior Fund staff interviewed noted the limits to the catalytic role of this instrument. The paper advises against increasing RFI access limits, but suggests that the catalytic role might be strengthened through use of parallel Staff Monitored Programs (SMPs) where relevant.

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## INTRODUCTION

**1. The FCL, PLL, and RFI were created as part of the reform of the GRA lending toolkit in response to the 2008 financial crisis.** The FCL and the PLL (as well as its predecessor the Precautionary Credit Line, or the PCL) aimed at strengthening the Fund's crisis prevention and resolution toolkit. Through a distinct qualification framework based on criteria relating to the strength of members' policies, institutions, and policy track record, they were designed to bolster confidence in members qualifying for these instruments and ameliorate balance of payments pressures. They were also aimed at reducing stigma associated with using Fund resources by involving limited or no ex post conditionality. The FCL was tailored to members with very strong economic fundamentals, institutional frameworks, and policy implementation records, while the PLL was tailored to members with sound economic policies and fundamentals but with some remaining vulnerabilities. The RFI was created to broaden the Fund's emergency assistance with a streamlined and more flexible instrument within the credit tranches, replacing previous policies for post-conflict situations and natural disasters.

**2. The 2011 review of the FCL and PCL found that both instruments had generally been successful in meeting their objectives.** In particular, the announcement of a request for an FCL or PLL arrangement reduced significantly the sovereign bond spreads of the requesting members, suggesting a reduction in the likelihood of a crisis. For FCL users, spreads were lower than could be explained by fundamentals while exchange rate volatility was lower than other highly rated emerging markets (EMs). These benefits were found to extend beyond the three FCL users, with positive spillovers to a number of other countries that were seen by market participants as likely qualifiers for this instrument. For the FCL and PLL users, access to Fund resources strengthened their buffers, providing a temporary supplement to reserves, a point underscored by many Directors in the context of both the 2011 Review and the discussion of Assessing Reserve Adequacy (ARA).

**3. At the same time, the 2011 review of the FCL and PCL led to a number of policy changes to allow more flexibility to respond to members' needs, as well as to increase transparency in the application of these instruments.** Specifically, the Fund replaced the PCL with the PLL, which permits the approval of an arrangement for members facing an actual balance of payments need at the time of approval. PLL arrangements can also have durations as short as six months (See [Supplement](#), Section I). In the 2011 review, the Executive Board noted that access discussions should be made more transparent and comparable across countries. To capture the importance of institutional strength, Directors also noted that qualification should rely more on qualitative and forward-looking aspects of institutional strength and policy track record.

**4. Notwithstanding the recent period of heightened market volatility, usage of the FCL and PLL remains relatively modest.** For the FCL, the original three users—Colombia, Mexico and Poland—have requested successor FCL arrangements, finding the signal on policies and the availability of financing useful against external tail risks. Morocco requested a PLL arrangement, which helped in strengthening market confidence in its policy agenda and facilitated better access to private capital markets. While there has also been some informal interest from other members in

these instruments, particularly in the PLL, none has resulted in a formal request. At the same time, some EMs—feeling vulnerable to heightened capital flow volatility but unwilling to request Fund arrangements—are seeking to expand regional financing arrangements (RFAs) and networks of bilateral swap arrangements (BSAs). Other smaller countries unable to participate in regional pooling are building substantial international reserve buffers for self insurance. To a large degree, this reflects the degree of political stigma related to Fund engagement that prevents some members from seeking preemptive Fund financial support.

**5. The role of the RFI remains untested.** Since its introduction in 2011, there has been no request by members to use this instrument. Nonetheless it may be premature to conclude that the RFI does not have a useful role in the Fund toolkit. The limited interest may reflect the low level at which potential access is capped, as well as the alternative buffers available to countries (including the RCF for PRGT-eligible countries) that have faced urgent balance of payments needs since its creation.

**6. This paper addresses four central themes:** (i) examination of the demand for the FCL and PLL in the context of the broader role of the Fund’s lending (including precautionary) instruments in the global financial safety net (GFSN); (ii) a review of the qualification/conditionality framework for the FCL and PLL, looking in particular at ways to reduce the uncertainty that has emerged regarding PLL qualification (i.e., the degree of underperformance in the qualification areas that can be accommodated before a member is no longer considered to have “sound” economic fundamentals, policies, and a track record of sound policy implementation); (iii) a consideration of factors relevant to the repeated use of the FCL including appropriate access and possible ways to support timely exit under FCL arrangements for members as external risks improve; and (iv) an investigation of whether the lack of demand for the RFI reflects instrument design or circumstances. The analysis in the paper builds on a survey of country authorities, interviews of senior staff involved in individual FCL and PLL arrangements and in potential RFI cases (from both the area and reviewing departments), as well as staff’s analytical work.

**7. The rest of this paper is organized as follows.** Section II discusses the role of the Fund in the GFSN, and the specific role of the FCL and PLL in the Fund’s lending toolkit. It also looks at the effectiveness of these instruments, augmenting previous analysis of their impact on sovereign yields. Section III reviews qualification and conditionality. Section IV reviews access and exit issues. Section V describes issues related to the RFI, while section VI discusses the treatment of precautionary arrangements in the Fund’s forward commitment capacity. A description of the FCL and PLL is presented in the Supplement, Section I, a summary of the survey responses is presented in the Supplement, Section II, and case studies are presented in the Supplement, Section III. A summary of the principal recommendations and findings are presented below. While the paper discusses a number of proposals for Board consideration, the implementation of some of these will require further Board discussions and the adoption of formal Board decisions, which will be taken up in subsequent Board papers.

## Summary of Principal Findings and Recommendations

### A. Global Financial Safety Net

- The Fund has a central role in the network of instruments comprising the GFSN, and the FCL/PLL instruments are important tools for crisis prevention and resolution. Regional financing and bilateral swap arrangements are generally not substitutes for Fund involvement.
- The FCL and PLL have had a positive impact on perceived crisis risk of recipients, including in the period of heightened capital market volatility, during the summer of 2013.
- Political stigma still constrains demand for Fund financing instruments, and more extensive outreach toward a broader set of stakeholders appears necessary, particularly in segments of the membership where stigma is strongest. Consideration could also be given to alternative modalities of engagement, in coordination with RFAs and central banks.

### B. Qualification/Conditionality Framework

- Experience to date suggests a general difficulty in identifying the minimum standard needed to meet the qualification requirements in practice, especially for the PLL. The review paper proposes aligning the qualification areas between the FCL and PLL— while leaving the respective standards unchanged for each instrument (i.e., “very strong” for FCL and “sound” for PLL)—as well as the development of indicators of institutional strength. These reforms should help increase transparency and predictability in qualification assessments.
- For PLL arrangements, greater use of ex-post conditionality (e.g., use of performance criteria or prior actions) may help with addressing remaining vulnerabilities.
- Despite significant difficulties, staff proposes maintaining the PLL with current access limits, but with the aim of thoroughly examining the case for the instrument at the time of the next review.

### C. Exit and Access

- Since the 2011 review of the FCL and PCL, the discussion of access in staff documents has generally become more thorough and transparent and there is no compelling evidence of undue repeated use of the FCL.
- Staff proposes to use a new indicator that measures country-specific external risk in order to better anchor access discussions.
- A time-based commitment fee could be considered as a tool aimed at strengthening incentives to support timely exit from high access precautionary arrangements and contain liquidity risks to the Fund.

### D. RFI and Other Issues

- The RFI remains a potentially useful instrument in the Fund’s toolkit. Access levels should remain unchanged, and the catalytic role might be strengthened through use of parallel SMPs where relevant.
- Full scoring of precautionary arrangements in the FCC, including of FCL and PLL arrangements that are treated as precautionary, remains appropriate.

### E. Next Review

- The next review of the FCL, the PLL and the RFI is proposed to be conducted on an as needed basis.

# THE GLOBAL FINANCIAL SAFETY NET AND THE FUND

## A. The Fund's Role in the Global Financial Safety Net

**8. A multi-layered GFSN has emerged in the wake of the 2008 crisis.** The GFSN comprises a loosely connected network of country insurance and lending instruments—encompassing multilateral institutions like the IMF, bilateral and regional financing arrangements, and individual countries' own reserves—that countries may draw on to cope with financing shortfalls, volatility and contagion from a crisis:<sup>1</sup>

- **Reserves.** Reserves are the primary external liquidity buffer held by most countries as a first line of defense against external pressures, and many countries have continued to build up reserves in recent years for precautionary and other purposes.<sup>2,3</sup>
- **Regional financial arrangements (RFAs).** Historically, regional financial arrangements were set up to promote regional integration and provide financial assistance to countries experiencing difficulties. While these date from the 1970s, they have expanded considerably since the start of the global financial crisis in 2008 (e.g., the Chiang Mai Initiative Multilateralization (CMIM) replaced the previous network of bilateral swap arrangements under the CMI in 2010; the EFSF was established in 2010, and its successor, the ESM, was set up in 2012). Most recently, Brazil, Russia, India, China, and South Africa announced their intention to establish a US\$100 billion Contingent Reserve Arrangement. The RFA lending frameworks vary considerably, and notwithstanding their proliferation, they have seen relatively limited use, outside Europe.<sup>4</sup> The EFSF/ESM is the most developed regional framework supporting deeper structural adjustment programs as well as precautionary arrangements similar to the Fund's credit lines.
- **Bilateral swap lines.** Bilateral swap lines have also expanded considerably since September 2008. As outlined in the recent *Assessing Reserve Adequacy* paper, core central banks expanded swap lines temporarily to smaller advanced markets (AMs) and some large EMs, although many were not permanent and have expired, leaving only a limited set of permanent swap lines between core central banks. More recently, a number of bilateral swaps have been agreed between major AMs and smaller AMs and EMs. For example, Japan has announced its intention to revive its U.S. dollar swap lines with Malaysia, Singapore, and Thailand, and to expand the one with the Philippines; it has also expanded its existing lines with India and Indonesia. China has

<sup>1</sup> See [Analytics of Systemic Crises and the Role of Global Financial Safety Nets](#), IMF Policy Paper, May 31, 2011, for a broader discussion of the GFSN.

<sup>2</sup> See *Assessing Reserve Adequacy—Further Considerations*, IMF Policy Paper, November 13, 2013

<sup>3</sup> See "The Fund's Mandate—Future Financing Role," [PIN No. 10/124](#), and "The Fund's Financing Role—Reform Proposals on Liquidity and Emergency Assistance and the Review of the Flexible Credit Line and Precautionary Credit Line," [PIN No. 11/152](#).

<sup>4</sup> See Table 1 of the [Stocktaking the Fund's Engagement with Regional Financing Arrangements](#), IMF Policy Paper, April 11, 2013, pp. 11-12.



also concluded local currency swap arrangements with a number of countries, partly with a view to promoting trade and investment.

- **International Monetary Fund.** In this multi-layered network, the Fund plays a key role in providing effective balance of payments support to members in a manner consistent with the Fund's Articles of Agreement and that provides adequate safeguards for the temporary use of the general resources of the Fund. In particular, given the size of its resources and its ability to pool risk globally, Fund financing helps act against rapid propagation of shocks across countries and regions. The Fund's financing instruments—combining resources, policy advice, and conditionality—serve as a framework for advancing effective policy adjustment that helps to address vulnerabilities and restore market confidence.

**9. Notwithstanding the separate layers of this global network, there are important synergies between the Fund and other layers of the GFSN.** Some RFAs and BSAs have linked their financing explicitly to Fund arrangements, making them complementary to Fund financing and increasing firepower in a coordinated response to a crisis. There have also been less formal but useful consultations and links with other regional and bilateral resources. While BSAs are in some ways similar to precautionary access under Fund arrangements, the two are not substitutes—BSAs typically focus on shorter periods of liquidity stress and have only been open to a limited set of countries, usually during select systemic events. Regarding reserves, the Board has viewed the FCL and PLL as temporary supplements to reserves during periods of heightened risks. In fact, it was expected that the availability of these instruments could limit the extent of self insurance.

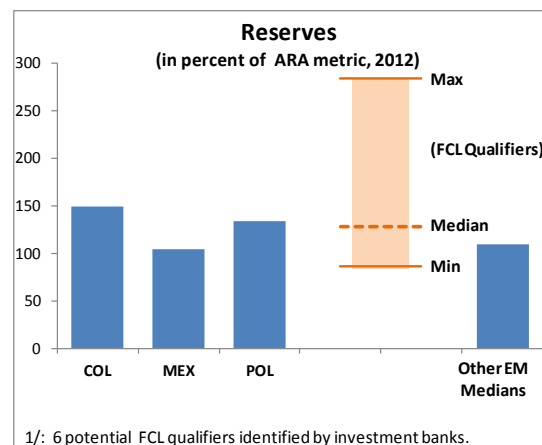
**10. Strengthening the GFSN was a central part of the official sector's response to the crisis.** The 2008 crisis exposed weaknesses in the GFSN and gave the impetus for a set of far-reaching reforms of the Fund's resources and lending instruments. In particular, the crisis highlighted the importance of having in place effective shock buffers for crisis countries and "crisis bystanders". To provide the Fund the resources to meet the potential needs of the membership and the ability to play an effective crisis prevention role, the Fund quadrupled its resources and revamped its lending toolkit. The latter led successively to improvements in the design and availability of precautionary SBAs, including High Access Precautionary Arrangements (HAPA), and the establishment of the FCL and the PCL/PLL, allowing the Fund to provide upfront contingent financing for countries that had very strong or sound fundamentals and policies, respectively, but were nevertheless potentially affected by a crisis originating elsewhere.<sup>5</sup>

**11. Nonetheless, despite progress made, questions remain about the effectiveness of the overall GFSN in preventing and responding to systemic crises.** In particular, the fragmentation of the network of RFAs and BSAs has increased since the crisis, while the demand for precautionary

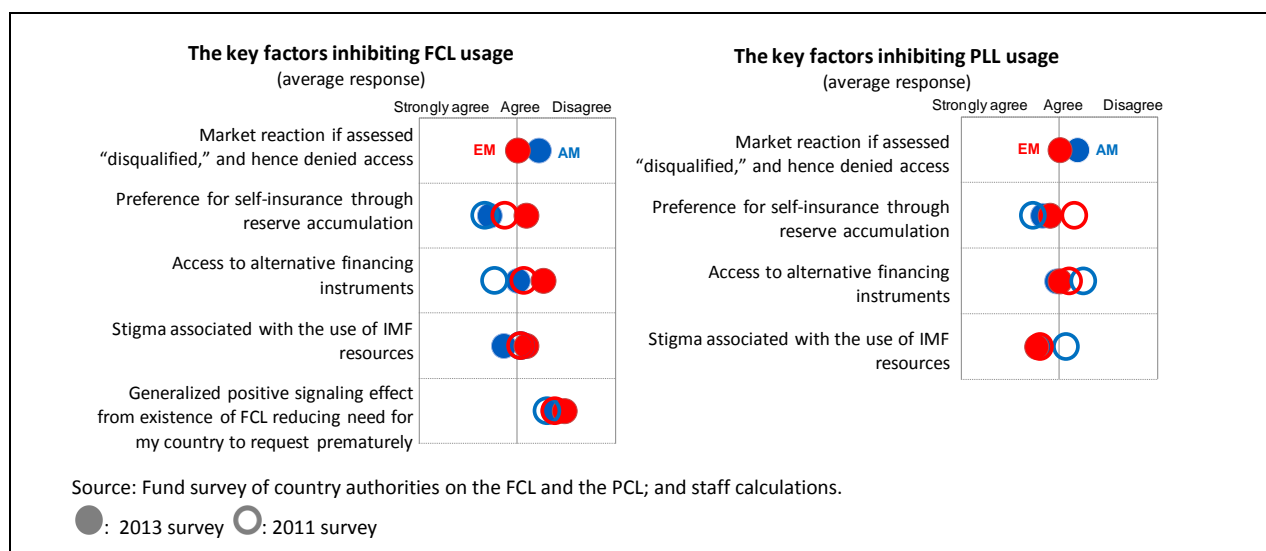
<sup>5</sup> [GRA Lending Toolkit and Conditionality—Reform Proposals](#), IMF Policy Paper, March 13, 2009; [The Fund's Mandate—Future Financing Role—Revised Reform Proposals and Revised Proposed Decisions](#), IMF Policy Paper, August 25, 2010; and [The Fund's Financing Role—Reform Proposals on Liquidity and Emergency Assistance](#), IMF Policy paper, October 28, 2011.

financial assistance from the Fund under the FCL and PLL has been relatively limited. This limited demand is despite the risks posed by capital flow volatility seen in recent months.

- One view is that demand may not have been as weak as perceived given the limited number of potential qualifiers. Although the universe of qualifying countries is not well defined (since the framework does not allow for prequalification), the three FCL users represent a significant subset of potential FCL users judged by the investment community as FCL-eligible. A number of these “potential qualifiers” have had relatively high external buffers and therefore may not have felt the need for additional insurance.



- An alternative interpretation, supported by the survey responses is that there is demand for insurance but that members continue to be reluctant to approach the Fund in the absence of acute financing difficulties. This reluctance distorts the GFSN, and results in additional pressure on the other elements of the safety net (BSAs, RFAs, and reserves). This is not a new issue and relates to the stigma associated with the Fund. The experience of the crises in the late 1990s and early 2000s aggravated stigma, particularly in Asia and Latin America. While conditionality is part of an effective policy response to strengthen fundamentals and policies, which is key to the restoration of market confidence, it has also given rise to a sense of intrusiveness associated with Fund-supported programs. Public opinion contributes to a perceived “political cost” associated with requesting financial assistance from the Fund. As a result, some countries have shied away from requesting precautionary Fund financial assistance, including during the recent bouts of market volatility, despite their desire for insurance. Notably, there has been no sign of interest in the new six-month form of the PLL, which was created in 2011 specifically for short-term liquidity-related BoP needs, and has FCL-like characteristics. Instead, some countries have opted for alternative financing mechanisms such as bilateral swap lines from reserve-currency central banks and loans from multilateral development banks (Box 1).



**12. This difficulty with stigma seems more related to the Fund as an institution than to individual financing instruments.** Despite the 2009-11 reforms, which responded to concerns about Fund lending policies, there has been an ongoing drive by several members to strengthen RFAs, expand bilateral swap lines, and further accumulate international reserves. This likely implies that stigma is broader in nature and relates to the Fund as an institution rather than to the design of specific instruments. The apparent positive assessment by markets of FCL users (discussed in Subsection B) also implies that the stigma is likely political and not economic in nature. To the extent that countries delay approaching the Fund, and do so only when pressures have become acute, crisis resolution becomes more difficult and costly both for the affected member and possibly for others through larger spillovers. Some suggestions on possible steps the Fund could take to address this problem appear in Subsection C.

## B. The Role of Credit Line Instruments within the Fund’s Lending Toolkit

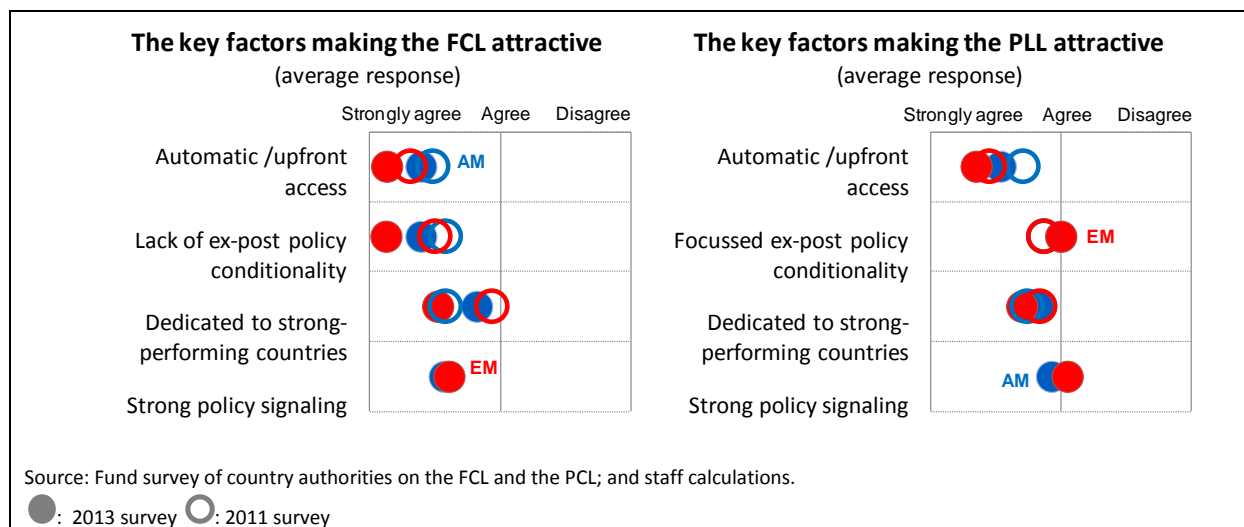
**13. The FCL was established in March 2009 as a means to enhance the Fund’s crisis prevention toolkit.** It was designed to provide large, upfront financing to members with very strong fundamentals and policies. The novel feature of the FCL was the introduction of a qualification framework to assess the strength of the member’s fundamentals and policies ex ante. Since access to financing under an FCL arrangement is restricted to those members that meet the strict qualification criteria, purchases are not subject to ex post conditionality. The design of the FCL is aimed at flexibility—it could be used to address either potential or actual financing needs stemming from any type of balance of payments problem; the FCL was established as a window in the credit tranches (not a special facility) with the same repurchase periods as the SBA (3¼ to 5 years), and there are no restrictions on requesting a successor arrangement under the FCL. The FCL was modified in August 2010 to increase its attractiveness by, inter alia, eliminating the implicit access cap (of 1,000 percent of the member’s quota), lengthening the duration of arrangements (from six months or one year to one year or two years) and reducing the frequency of reviews from semiannual to annual.

**14. The PCL and PLL aimed to respond to members’ desire to have some of the benefits of the FCL spread to a larger subset of the membership.**

The PCL aimed to provide effective crisis prevention to members that have sound fundamentals and policies but also some remaining vulnerabilities that would prevent them from meeting the FCL’s qualification requirements. In light of these vulnerabilities, the PCL combined ex ante conditionality (qualification criteria) with focused ex post conditionality, based on six-monthly reviews underpinned by a quantified macroeconomic framework. Under a PLL arrangement, indicative targets (ITs) and the standard performance criteria (PCs) on trade or exchange restrictions and external arrears are established, with conditionality options including quantitative PCs, prior actions (PAs), and structural benchmarks (SBs). Overall access was capped at 1,000 percent of quota. The current PLL made use of the PCL’s qualification and conditionality framework but permits members with actual balance of payments needs to request an arrangement and also allows for arrangements of six-month duration to meet short-term balance of payments needs.

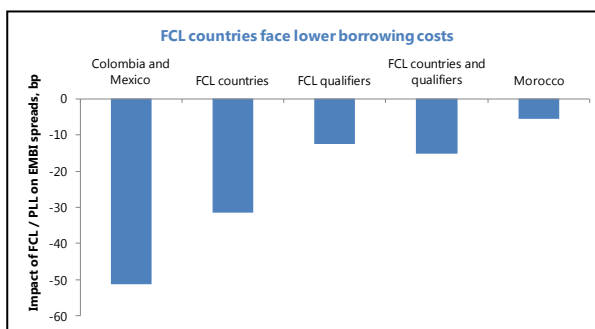
**15. Survey results and discussion with country authorities confirm that both the FCL and PCL/PLL have helped bolster confidence and moderate BoP financing pressures for members availing themselves of the new instruments.**

Survey respondents, both from EMs and AMs, agreed that the FCL had been a key element in a strengthened IMF lending tool kit. Respondents underscored frontloaded financing, alongside more streamlined ex post conditionality, and the strong policy signaling aspect of these new instruments. Senior Fund staff interviewed for this review also argued that the PLL made it possible for the Moroccan authorities to come to the Fund early, thereby limiting a possible weakening in external and fiscal positions.



**16. Empirical analysis of sovereign spreads is also generally corroborative of the positive impact of these instruments, including in the period after May 22 2013,**

when expectations about the timing of Fed tapering changed (Box 2). Econometric results broadly confirm that the FCL had a significant



and positive impact on the high frequency portfolio flows and generally in limiting the spreads not only of countries with an FCL arrangement but also of those perceived by the markets as qualifying for an FCL arrangement. For Morocco, the only new user of the PLL since the last review, the country-specific evidence also points to a marked reduction in borrowing costs following the approval of the arrangement. In addition, analysis of the impact on spreads and high frequency measures of portfolio flows during the most recent bout of market turmoil (post-May 22) also corroborates the view that FCL users were less affected.

**17. The introduction of multiple instruments, however, has created a system of tiering.** The tiering of instruments across the membership was partly intentional: one of the guiding principles of the reforms was to modernize Fund conditionality with a view to tailoring it to the varying strength of members' fundamentals and policies, and to alleviate stigma attached to the use of Fund financing by creating new instruments either without ex post conditionality (FCL), or with limited ex post conditionality (PLL/PCL). Although the concern about tiering had been raised prior to the establishment of the PCL in August 2010, the Fund opted for creating a new instrument rather than broadening the availability of the FCL, so as to preserve the FCL's high qualification requirements. It was also acknowledged that the SBA would likely bear the brunt of stigma, but this was not seen as problematic insofar as the SBA continued to be used for crisis resolution purposes. As it turned out, the existence of three tiers (FCL, PLL, and SBA/EFF) seems to have led to the FCL and PLL stigmatizing use of the SBA and EFF. Members that do not qualify for the FCL and PLL face a (perceived) disincentive to request a SBA or extended arrangement, increasing the risks of delays in requesting Fund support. This concern over the role played by the PLL was expressed by a number of internal interviewees.

**18. The current structure has also complicated the qualification assessment process.** Partly because there is substantial room for judgment in assessing qualification, discussions on whether the member's fundamentals and policies are strong enough to qualify for the FCL, or especially the PCL/PLL, have sometimes proven to be difficult and protracted (see Box 3). This has, in turn, led to costly delays in putting in place Fund-supported programs in some cases.

## C. Possible Reform Proposals

**19. To address the issue of stigma, more extensive outreach towards a broader set of stakeholders appears necessary.** Policymakers' reluctance to come to the Fund appears to stem largely from the persistently negative image that the Fund has among many civil society opinion leaders, NGOs, and the general public, particularly in countries affected by past crises. Stigma seems entrenched in the public opinion partly because the Fund is less visible to them, and they are less likely than policymakers to be aware of the significant reforms undertaken by the Fund in recent years. It follows that Fund staff needs to redouble their efforts to reach out to this broader array of stakeholders and explain how the Fund has learned from the past and changed—including through the institution's ongoing work to address governance and representation concerns.<sup>6</sup> Executive

<sup>6</sup> Some lessons could be drawn from the (quite successful) efforts made since the late 1990s to overcome Fund stigma in low-income countries—including the value of concerted engagement by Fund staff and management,

(continued)

Directors and country authorities could also play an important role in facilitating the outreach and improving the public perception of the Fund.

**20. The Fund could also consider alleviating stigma in more operational ways.** Changing “hearts and minds” will be a long-term endeavor. In the meantime, demonstrating successful and mutually beneficial engagement is likely a critical aspect in overcoming the legacy of the past. In this regard, attempts to overcome the “first mover” problem could help.

- ***Synchronized Arrangements.*** A member may be reluctant to request Fund financing individually for fear of negative public perception in the event that it turned out to be the only member to have approached the Fund among its peers (e.g., a group of countries within a region). This first-mover problem could be addressed through coordination among these members to request Fund financial assistance—whether under the FCL, PLL, or precautionary SBA—concurrently. Such synchronized approval of FCL (and other types of) arrangements for multiple countries is feasible under the existing policies (SM/10/291 Revision 1, 11/4/10), though there have been no such concurrent approvals so far. This may, in part, be because all expressions of interest by individual members need to be kept confidential unless the member consents to sharing the information with other members contemplating a request.
- ***Cooperation with RFAs.*** This could involve coordination and cooperation with RFAs in co-financing, which may appear more palatable to some countries in need than engaging solely with the Fund. RFAs could also provide a forum for consultation among their members on synchronized requests for Fund support, if that were perceived as helpful in overcoming the first mover problem. However, RFAs are highly heterogeneous—in different stages of development and with diverse mandates and governance structures—so the modalities for coordination of Fund financing with RFAs would need to be carefully considered.
- ***Supporting central bank swap lines.*** Another possible avenue would be for the Fund to work with interested central banks to facilitate and support a network of bilateral swap arrangements amongst countries. The Fund’s role could range from provision of economic assessments and monitoring to a role which involves the use of the Fund’s resources (under its existing facilities and policies). The latter role would raise a number of difficult policy and practical issues, especially in terms of managing the extent of risk that the Fund could be asked to take on—a concern that could also apply in the context of financial engagement with RFAs. If the Board wishes, staff could explore the modalities, benefits, and possible difficulties of these approaches in a subsequent Board paper.
- ***Prequalification.*** A related reform could be to consider prequalification for FCL and PLL arrangements, but this approach has significant drawbacks. Prequalification could help overcome the first mover problem—since country authorities would not need to approach the

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supported by well-designed material that is accessible and tailored to the target audiences. Policy Support Instruments also bolstered the Fund’s image in frontier LICs.

Fund ahead of making a formal request. In some cases, this may reduce the domestic political price of Fund engagement. Options for prequalification could include the creation of a regular list, or an assessment, at the request of a member, during its Article IV consultation, and would in either case need to be subject to regular review. Nonetheless, as emphasized previously by the Board and reiterated by a number of the interviewees for this review, prequalification would create serious problems of its own. First, publishing a prequalification list may likely raise concerns about the countries not appearing on the list and risk the Fund being seen as a “rating agency.”<sup>7</sup> Second, removing countries that no longer qualify from the list is likely to prove difficult in practice given the potential market reaction. Third, a prequalification list may add another layer to the tiering of the Fund’s instruments. There is also little support for prequalification in the survey conducted for this paper (see [Supplement](#), Section II).

**21. Another option to increase the flexibility of the FCL and PLL could be to establish them as revolving credit lines within the period of each arrangement.** Under this option, repurchases under FCL and PLL arrangements during the period of the arrangement would restore access by the amount of the repurchase. Currently, as is the case with any other Fund arrangement, available access is reduced by the amount of the purchase when drawn, and will not increase again even when repurchased during the arrangement. The member survey suggests, however, limited appetite among the membership for this amendment ([Supplement](#), Section II).

## QUALIFICATION/CONDITIONALITY FRAMEWORK

**22. A critical aspect of both the FCL and the PLL is the application of rigorous qualification criteria.** There are no “bright line” numerical qualification thresholds for either of these instruments (especially the PLL) and judgment is an integral part of qualification assessments. While qualification decisions to date have been broadly appropriate, the process of assessing qualification has at times been difficult, and respondents to the membership survey, particularly those from EMs, have called for greater predictability in qualification assessments.<sup>8</sup>

- The **FCL** qualification assessments have generally been satisfactory.<sup>9</sup> For each of the three FCL arrangements, the assessments established that the requesting member had very strong policies and institutions, as well as a track record of policy implementation.
- The assessment process for the **PLL** has been more challenging:
  - **Morocco.** While Morocco was assessed as having sound economic fundamentals and institutions, despite some moderate underperformance in the areas of fiscal policy and

<sup>7</sup> In addition, consistent with the existing legal framework, including the Fund’s Transparency Policy, to the extent that any list would be produced, there would be voluntary but presumed publication. If a member were to object to publication, the Fund’s options would include either omitting the member from the published list, or not publishing a list at all.

<sup>8</sup> See Section II of the [supplement](#) to this paper.

<sup>9</sup> See the country case studies in Section III of the [supplement](#) to this paper.

external position, slippages in the fiscal area after the first review raised questions about its continued qualification in the absence of corrective measures. Subsequent steps sought to address these slippages, in the context of ongoing qualification assessments (see [Supplement](#), Section III).

- **Others.** Since the inception of the PCL, there have been a number of informal approaches from members who did not end up proceeding with a formal expression of interest in or request for a PCL/PLL arrangement. The assessments in several of these cases were fraught with difficulties (Box 3), a point also raised in interviews with senior staff. The problems identified in these cases included difficulties in assessing both the strength of institutional frameworks and the extent of “underperformance” in qualification areas that would be permitted while still qualifying for assistance, insufficiently robust track records, and attempts to use “upfront measures”<sup>10</sup> as a substitute for weak track record. The difficulties would seem to reflect the fact that, while the framework allows a qualifying member to have some underperformance in at most two qualification areas, it does not provide sufficient *operational* clarity over the extent of acceptable underperformance.

**23. The 2011 Review of the FCL and the PCL sought to address difficulties in the amendment of the qualification criteria through greater emphasis on qualitative factors** and, possibly, more direct use of the quantitative assessments in the in-house vulnerability work. In the context of the review, the Board endorsed the use of forward-looking measures of institutional strength as well as of recent FSAP and ROSC assessments for FCL/PLL users and assessments of their policies in the context of very recent Article IV consultations. In addition, at the time of the review, Directors noted the scope for better use of the indicators from the staff’s in-house vulnerability work, which could further enhance the clarity of qualification assessments. However, the use of these endorsed tools has not helped address the existing difficulties.

**24. A potential source of difficulty could be the fact that the qualification criteria for the two instruments, while closely related, differ.** FCL qualification assesses performance relative to nine specific criteria while, for the PLL, performance is assessed in five general areas (the table below shows the mapping between the two).<sup>11</sup> In addition to this “ex ante conditionality,” PLL arrangements provide for ex post conditionality focused on addressing remaining vulnerabilities, as discussed in Subsection C below. While the qualification criteria for the two instruments are related, the fact that there are some specific differences could, as mentioned in the 2011 review of the FCL and PCL, make the “FCL-PLL dividing line” ambiguous.

<sup>10</sup> Upfront measures, for the purpose of this paper, refer to measures that are taken by the authorities on their own initiatives but fall short of macrocritical measures used as a basis for qualification. Such upfront measures are different from prior actions, which are part of conditionality aimed at addressing the remaining vulnerabilities after qualification.

<sup>11</sup> For a detailed description of current policy, see Section I of the [supplement](#) to this paper.



### Mapping Between FCL Qualification Criteria and PLL Qualification Areas

PLL Qualification Area	FCL Qualification Criterion
I. External Position and Market Access	<ol style="list-style-type: none"> <li>1. Sustainable external position</li> <li>2. A capital account position dominated by private flows</li> <li>3. A track record of steady sovereign access to international capital markets at favorable terms</li> <li>4. A reserve position that is relatively comfortable when the arrangement is requested on a precautionary basis</li> </ol>
II. Fiscal Policy	<ol style="list-style-type: none"> <li>5. Sound public finance, including a sustainable public debt position determined by a rigorous and systemic debt sustainability analysis</li> </ol>
III. Monetary Policy	<ol style="list-style-type: none"> <li>6. Low and stable inflation, in the context of a sound monetary and exchange rate policy</li> </ol>
IV. Financial Sector Soundness and Supervision	<ol style="list-style-type: none"> <li>7. Absence of bank solvency problem that pose an immediate threat of a systemic banking crisis</li> <li>8. Effective financial sector supervision</li> </ol>
V. Data Adequacy	<ol style="list-style-type: none"> <li>9. Data transparency and integrity</li> </ol>

Source: PLL Operational Guidance Note

**25. Experience to date also highlights the importance of data adequacy.** The guidance notes for the FCL and PLL recommends that data adequacy qualification be judged against “subscription to the Special Data Dissemination Standard (SDDS) or a judgment that satisfactory progress is being made toward meeting its requirement.” Recent experience, however, suggests that a more rigorous standard may be warranted, with SDDS subscription a necessary but not sufficient condition for qualification. In particular, this standard may not be sufficient to ensure timely and reliable data to monitor changes in the extent of vulnerabilities consistent with the review timeline of the FCL or PLL.<sup>12</sup> As such, the operational guidance on the interpretation of the data adequacy standard will be reviewed with the guidance note following this paper.

**26. Notwithstanding these difficulties, staff is of the view that both instruments should remain as part of the lending toolkit at present.** However, staff would recommend a number of steps that could be taken to strengthen the qualification assessment framework for the PLL. Given the considerable similarities in the operational aspects of these instruments, staff believes that these measures should also apply to the FCL.

## A. Qualification Assessments

**27. Staff proposes that two key steps be taken to improve the transparency and predictability of qualification assessments:** (i) the unification of the FCL and PLL qualification areas; and (ii) the use of indicators signaling institutional strength.

<sup>12</sup> While FCL users cannot have remaining vulnerabilities upon entering an FCL arrangement, reviews conducted under FCL assess whether the member continues to qualify, and so will need to assess whether vulnerabilities have emerged since the approval of the arrangement.

**28. Under the first proposal, the FCL policy would be amended to merge the nine specific qualification criteria into the five broad qualification areas specified in the PLL decision**

(mapping provided in text table in ¶24).<sup>13</sup> Staff does not propose, however, to change the qualification standards for either instrument; in effect the standard for policies, frameworks and institutions for the FCL and PLL would remain as is. That is, qualification for FCL will still require very strong economic fundamentals and institutional policy frameworks, but this would now be signaled by strong performance against all of the five qualification areas (whereas for the PLL, strong performance is needed for most (i.e., 3 out of 5) qualification areas). The qualification requirements for the PLL would remain unchanged (see the [supplement](#) to this paper). This change would make qualification discussions more comparable across arrangements, and use the resulting accumulated experience with qualification assessments against the separate FCL and PLL standards to better inform decisions going forward.

**29. The 2011 FCL/PCL review noted that qualification assessments could place a stronger focus on institutional strength and forward-looking policy commitments.** In the context of the review, the Fund sought to address this through greater use of timely assessments of members' policies in Article IV consultations, as well as recent FSAPs (including updates and FSAP stability modules), and relevant ROSCs. While these tools provide critical assessments of the institutional strength in specific policy areas, they are infrequently updated (and may not be available at the time of a specific qualification request) and do not provide an overall assessment. It is therefore useful to examine whether the more qualitative discussion of policy frameworks and the assessment of the relevant criteria under the FCL and PLL could be usefully complemented with high frequency and objective indicators of institutional strength.

**30. To help identify such measures of institutional strength, staff has looked at the role of institutions in past large fiscal adjustments** (see Box 4). An examination has been made of institutional and political risk scores drawn from the International Country Risk Guide (ICRG data) of the Political Risk Service (PRS) group, a private sector risk analysis firm, and the World Bank's database of political indicators. Preliminary findings, based on these sources, suggest that large fiscal adjustments are indeed associated with situations in which there is a lower risk of government instability and corruption and more executive control. A similar set of indicators is found to be important in understanding which EMs are able to successfully implement counter-cyclical fiscal and monetary policies.

**31. Staff proposes that these type of indicators of institutional strength be developed and used by staff to usefully complement the existing quantitative indicators as specified in the FCL and PLL guidance notes.** Further work may be needed to determine which particular indicators are most informative. These could then be used to help inform the judgment on the strength of the quality of institutions, and the forward-looking assessment of whether institutional frameworks can deliver the required policy adjustment in the event of an exogenous shock. In this regard, they

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<sup>13</sup> If the Board endorses these approaches, a formal Board decision implementing this approach will be issued to the Board for consideration.

would be an additional aid to judgment in assessing the requirement for very strong/sound institutional policy frameworks embedded, respectively, in the FCL and PLL policy decisions. Of course, consistent with the Guidelines on Conditionality, any such indicators will be designed in a manner that pays “due regard to the domestic social and political objectives” of members.

## B. Ex-Post Conditionality in PLL Arrangements

**32. Under the PLL, focused ex-post conditionality is critical to address remaining vulnerabilities.** These remaining vulnerabilities are expected to be assessed at six-monthly reviews under the arrangement, and addressed through a focused set of ITs and, as necessary, PAs, PCs, and SBs.<sup>14</sup> The degree of required ex post conditionality is expected to be inversely related to the member’s strength of performance under the PLL’s qualification framework.

**33. In practice PCL/PLL ex-post conditionality so far has relied almost exclusively on indicative targets.** No PCs (other than the standard continuous PCs) or PAs have been used, in spite of the existing vulnerabilities identified at the outset:

**FYR Macedonia** was assessed as having moderate vulnerabilities in the external and data areas:

- *External:* Although the staff report for the PCL arrangement request had noted that market access remained vulnerable to adverse developments in EU sovereign debt markets, it was not until the first review (and after the purchase) that a SB was established on debt management practices.
- *Data:* FYR Macedonia had committed to join the Special Data Dissemination Standard (SDDS) prior to the PCL arrangement request and joined the scheme in November 2011. However, joining the SDDS arguably does not necessarily ensure improvement in the quality of data provision.

**Morocco** was assessed as having moderate vulnerabilities in the fiscal and external areas:

- *Fiscal:* The staff report for the PLL arrangement request concluded that increases in the fiscal deficit represented moderate underperformance. Key factors were identified in the context of the request and reviews, such as energy subsidies, the wage bill, and a tendency to compress public investment, but SBs were not incorporated to address remaining vulnerabilities in these areas. Although the staff report for the second review extensively discussed staff’s concerns on the shortcomings in the budget framework, and the need for a significant reduction in subsidies, no corresponding SBs or ITs were established. However, staff and the authorities reached understandings before the second and third reviews on a set of actions to reinforce the budget framework and to reduce fiscal vulnerabilities.

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<sup>14</sup> Prior actions only apply to PCL/PLL cases, as FCL arrangements are only subject to ex-ante conditionality in the form of qualification criteria.

- *External:* Upon completion of the second review, the vulnerabilities were assessed as moderate despite a current account deficit of 10 percent of GDP. Staff expressed concern about the slow progress on structural reforms and stressed the need to target the most binding constraints on competitiveness. The authorities agreed to engage in policies to foster a business environment more conducive to growth and jobs, but again no SBs were established.

**34. Moreover, when compared to high access precautionary SBAs (HAPAs), the total extent of PCL/PLL ex-post conditionality is remarkably limited.** Although PLL arrangements should by design generally have less conditionality than HAPAs, the difference is striking. Under the two PCL/PLL arrangements, only two quantitative indicators—NIR and overall fiscal deficit—were established as ITs (one IT per quarter), compared to an average of six indicators per quarter established as either ITs or quantitative PCs under the four HAPAs (Brazil, Costa Rica, El Salvador, and Guatemala). Moreover, no non-standard PCs have been established in PCL/PLL arrangements, compared to an average of around five indicators per quarter for HAPAs.

**35. Targeted use of ex-post conditionality could help address remaining vulnerabilities identified in members with PLL arrangements.** Slippages have occurred in both the PCL/PLL cases to date, largely in the areas of remaining vulnerabilities identified at the time of qualification. Relatedly, staff guidance could clarify that the adoption of, or commitment to implement, “upfront measures” is generally inconsistent with the PLL’s qualification framework that assesses, inter alia, track record of policy implementation and soundness of institutional frameworks. As such, upfront measures should not be used as a basis for qualification and cannot substitute for the member’s track record that informs qualification assessments. By contrast, macroeconomic or structural policy adjustments already underway, and being credibly implemented ahead of qualification may form part of the qualification assessment.

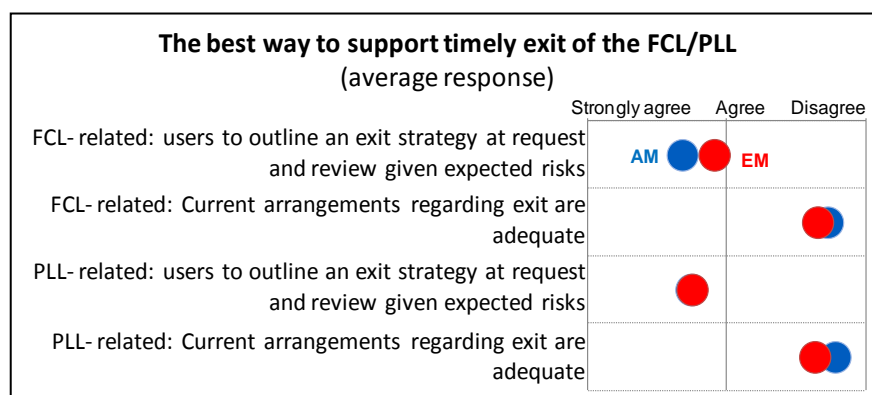
## C. Possible Reform Proposals

**36.** Staff proposes: (i) to unify the qualification areas for the FCL and the PLL, while maintaining the separate standards for these instruments (i.e., “very strong” for the FCL and “sound” for the PLL); and (ii) to develop and use selected indicators of institutional strength to augment the existing quantitative indicators for qualification for the FCL and the PLL.

## ACCESS AND EXIT

**37. A recurring theme at the Board has been the successive use of FCL arrangements, and whether this is consistent with the purposes of the instrument.** Concerns over (lack of) exit have become increasingly vocal at the recent successive requests of the three FCL arrangements. Directors have called for well-articulated exit strategies, and highlighted the importance of crafting communications surrounding exit. These viewpoints also emerged clearly from the survey conducted for this review. Directors have noted, in particular, the importance of linking requested access to global risks, and called explicitly for a reconsideration of access during the Colombia arrangement. To cite recent summings-up:

- **Mexico** (December 2012): “Noting that a protracted use of the FCL may not be in line with the original purpose of the instrument, Directors welcomed the authorities’ intention to take further steps towards exit from the FCL when improved external conditions allow. In this connection, Directors underscored the importance of crafting and communicating a credible exit strategy.”
- **Poland** (January 2013): “Noting that a protracted use of the FCL may not be in line with the original purpose of the instrument,... [Directors] welcomed the authorities’ intention to craft and communicate a credible strategy for exiting from the arrangement when external conditions improve. Some Directors questioned the need to increase the nominal access in the successor arrangement, pointing to Poland’s strong macroeconomic fundamentals and broadly adequate reserves.”
- **Colombia** (June 2013): “[Directors] welcomed the authorities’ intentions to continue to treat the FCL arrangement as precautionary, and to gradually reduce the economy’s dependence on contingent external financing as risks subside. Most Directors called for a clear, timely exit strategy, with a number of them seeing a reduction in access as part of the strategy, and some suggesting consideration by the authorities of an early cancellation of the arrangement. In this context, Directors were encouraged by the authorities’ readiness to review the access level during the first review.”



**38. Staff has examined whether the limited signs of exit are a function of the design of the instrument, or simply reflect the prolonged period of elevated global risks.** Given the insurance nature of the instruments, the last review of the FCL and the PCL elaborated on the explicit link between “exit” and access identified by the Board. In particular, it noted that in the discussion of *The Fund’s Mandate—The Future Financing Role—Reform Proposals*, Directors agreed, in addition to other relevant factors justifying lower access, that access under the FCL “would normally be expected to decline in successor arrangements whenever improvements in official and private financing prospects have reduced the member’s potential or actual balance of payments needs in a sustained manner” (PIN/10/124). This expectation, extended to the PLL, therefore “sets the minimum parameters for exit discussions, [and] ... clearly limits the expectation of declining access to episodes

of declining country risk (improving financing prospects), as forcing poorly timed exit could hurt the exiting country and others.<sup>15</sup>

**39. To address the questions posed above, this section assesses three interrelated issues:** (i) the evolution of the external environment, (ii) transparency in access discussions, and (iii) the role of commitment fees. The analysis of the external environment suggests that the absence of a move toward exit so far largely reflects the evolution of external risks for FCL cases. Nevertheless, external risks have subsided somewhat since the peak of the global financial crisis, and with risks and exit so intimately linked, it is reasonable to ask whether it is possible to better anchor the discussion of external risks, with implications for the severity of the adverse scenarios underpinning access. In the sections that follow, the paper considers these issues in more depth, as well as the possible role that price-based incentives might play in influencing access requests.

## A. Measuring External Risks

**40. An important element in any access discussion is the measurement of external risks.** As these risks decline over time, access would be expected to decline, which would be consistent with a member progressively exiting from arrangements under the FCL. The presence and extent of the relevant risks has been a major source of discussion at the Board during recent FCL requests, where country authorities have argued that external risks remain elevated, but some Executive Directors have perceived risks differently. In this context, it may be helpful to develop an objective measure of external risk that can guide future discussions on access.

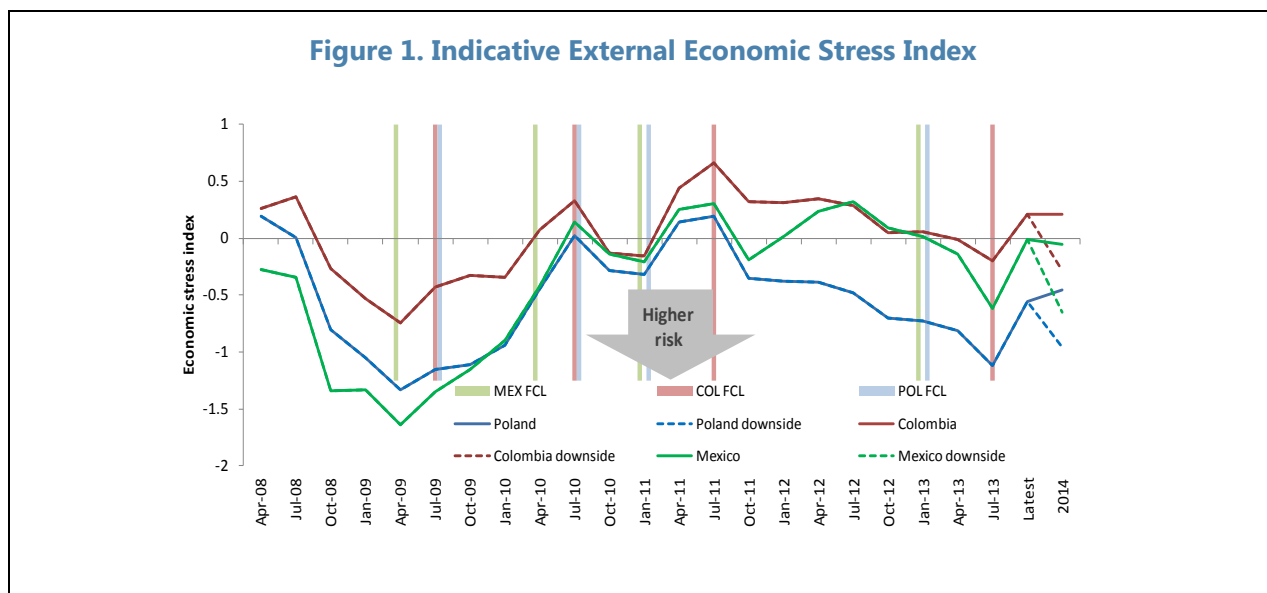
**41. Staff has explored the development of a new indicator of external stress (the “external economic stress index”).**<sup>16</sup> This external economic stress index would focus on areas of external vulnerability identified by country teams for each FCL or PLL user. In particular, for each FCL user, it would estimate the size of each vulnerability (scaled by GDP) listed in the most recent FCL country report. In the case of Poland, for instance, such exposures would include exports to the Eurozone, cross-border bank claims, FDI and portfolio capital inflows, and public external financing needs.

**42. Applying the illustrative external economic stress index to the three FCL users shows that external stress has abated for all of them since their first FCL arrangement requests** (Box 5 and Figure 1). Figure 1 confirms that most components of the index for the FCL users show stress levels lower than at the time of their first arrangement requests, when access under the FCL was subject to an informal cap. While all three users experienced a temporary worsening in their external environment in the summer of 2013 as portfolio funds fled emerging markets, external stress in Poland has remained higher due to its exposure to a weak Eurozone (and its banks).

<sup>15</sup> IMF, 2011, *Review of the Flexible Credit Line and Precautionary Credit Line*, pp. 27-28.

<sup>16</sup> While the issue of repeated use has not emerged in the context of the PLL, it is proposed that such an index could be used for both FCL and PLL arrangements.

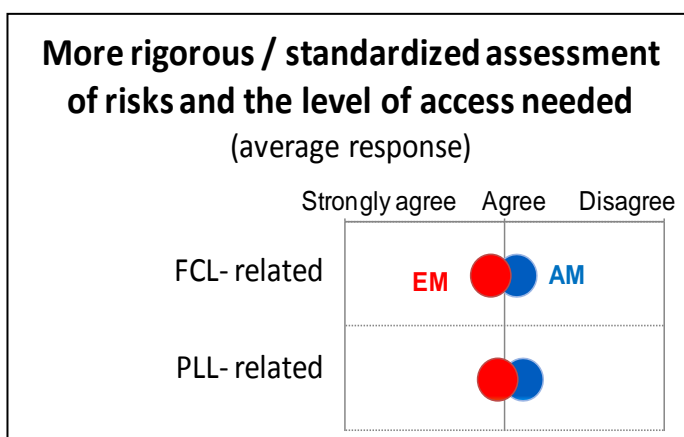
**43. However, forward-looking risks (based on downside scenarios) remain elevated.** FCL access discussions consider both actual stress and potential future external stress. Using the WEO and GFSR downside scenarios, external stress could return to levels seen in summer 2013 (Figure 1).



**44. The index presented here is only illustrative; the specification would need to be developed further before inclusion in the staff operational guidance note.** An important challenge for any aggregate index is to capture in a timely basis turning points in a country’s external risk environment. Such an index is, therefore, best seen as an additional indicator to inform judgments underpinning exit and access discussion, and should not be seen as a substitute for the judgment of the staff and the Board. Moreover, there is no intention to broaden the usage of the external economic stress index to other purposes within the Fund.

## B. Transparency in Access Discussions

**45. The 2011 review noted that FCL and PCL access levels broadly reflected potential BoP needs, but the shock scenarios differed markedly across cases, often without full explanations.** As with other types of Fund arrangements, access under the FCL and PLL should take into account well-articulated plausible downside scenarios. However, the last review of the policies found that the description of underlying scenarios, while improving over time, was relatively limited



and based mainly on country-specific experience that was not explained in detail. Beyond the scenarios, assumed reserve and access “cushions” also varied across FCL cases, with the cushion as large as a quarter of access in some early cases without full explanation.<sup>17</sup>

**46. To compare access assumptions across FCL-PLL cases and facilitate a more transparent approach to determining access levels, the last review developed a unified framework based on general EM experiences.**<sup>18</sup> In the context of the 2011 review, the Board endorsed the proposal that access should be directly linked to the actual or potential BoP needs arising from a relevant adverse scenario, with clear explanations as to how the assumed shocks reflect global risks and country-specific circumstances. Any use of “cushions” should be carefully justified. For transparency and comparability, shocks could be chosen from a common distribution of relevant externally-driven “crisis” events, such as depicted in Figures 2a and 2b below. Staff reports are expected to discuss the severity of adverse scenario shocks chosen. Finally, projected reserve levels under adverse scenarios should be compared to minimum desirable reserve levels, based on relevant metrics.

**47. Access discussions in the most recent FCL-PLL staff reports have become more transparent than in the past, along the lines called for in the last review** (Table 1). There are much more detailed discussions of the assumptions regarding the main external variables and how they compare with the experiences during the 2008-09 global financial crisis, as well as with the assumptions under their previous FCL arrangements. In addition, good use has been made of the historical distribution of the impact of advanced economy slowdowns across all EMs, developed as a benchmark in the 2011 Review of the FCL and PLL. When compared with these distributions, it seems that the shocks assumed in adverse scenarios for FCL and PLL arrangements have become less extreme (and more clustered) over time for the first year of the scenario (Figure 2a), but are increasingly conservative, and severe, (especially for FDI and private short-term rollover) in the second year (Figure 2b). While the specific assumptions underpinning access scenarios have become less severe—in line with signs of falling external risk in figure 1—access levels remain high and a concern for some Directors. The increased access after the first Mexico and Poland FCL arrangements occurred despite the decline in external risk and reflects the removal of the implicit access cap in place until 2010.

**48. There is some tension between the risk discussions and the assumptions underpinning the adverse scenarios.** While the staff reports have identified main sources of risks and had a general assessment of the risk level, they did not make any apparent link between the degree of external risk and the size of shocks assumed. Instead, most of the shock assumptions were based on the members’ experiences during the global financial crisis or those used under previous FCL requests, with no discussion as to whether the evolution of the risk outlook justifies, as a plausible adverse scenario, the use of such scenarios. As a result, the assumed adverse scenarios differ

<sup>17</sup> In the FCL guidance note, such cushions are expressed in terms of “further potential downside risks on the BoP beyond those considered under the adverse scenario”. See [The Flexible Credit Line—Guidance on Operational Issue, Attachment I](#).

<sup>18</sup> Box 4 of [Review of the Flexible Credit Line and Precautionary Credit Line](#), 2011.



markedly across the latest FCL cases, and the membership survey undertaken for this review pointed to a desire for further standardization of the assessment of risks and access levels. For example:

- The **2012 FCL arrangement for Mexico** assumes that the shock scenario would be similar to the peak-to-trough change following the Lehman crisis (i.e., from 2008Q3 to 2009Q2)—this peak-to-trough change is larger than Mexico’s actual annual changes in 2008–2009 (due to some unwinding of the peak impact during each year) and relative to Mexico’s average experience over the last two decades, which may seem high given the evolution of external risks depicted in Box 5.<sup>19</sup>
- The **2013 FCL arrangement for Colombia** assumes a shock scenario less severe than the global financial crisis—the shock assumptions on remittances and all financial flows are on average half of those experienced during the global crisis. The latest FCL arrangement for Poland is somewhere in between, with shock assumptions on FDI, and equity flows broadly in line with the annual changes during the global crisis.

**49. The proposed economic stress index (in section A) could be used to help guide access discussions** in both FCL and PLL arrangements. For example, when the index indicates more elevated risks, the adverse scenarios should go further into the tail of the historical distributions; and similarly, when the index shows an improvement, the assumed shocks should be correspondingly smaller and closer to the center of the historical distributions. Figure 3 depicts the empirical distributions of adverse shocks presented in Figure 2a contrasted with the distributions based only on the height of the global financial crisis. Generally, the distribution associated with the global financial crisis has a larger mass in the left tail (and lower median) than that during more normal times, pointing to events further in the tail when the baseline economic stress index for a country is elevated. This suggests that the severity of the assumed event should reflect more directly the extent of external stress.

<sup>19</sup> This is particularly the case for the assumption of foreigners’ investment in peso-denominated sovereign bonds, which accounts for almost half of the financing gap under the adverse scenario. A net outflow under this category is assumed under the adverse scenario, which is in line with the peak-to-trough change but much more severe than the annual flows in 2008 and 2009, both of which are positive.

**Table 1. Assumptions Underpinning Adverse Shock Scenarios**

Shock	Colombia	FYR Macedonia	Mexico	Morocco	Poland
FDI	√√√ <sup>1/</sup>	√	√√	√	√√√
Portfolio investment outflows	X <sup>2/</sup>	X	√√	X	√√√
Other investment outflows	X	√	√√	X	√√√
Drawdown of foreign asset (inflows)	X	X	X	X	√
Exports	X	√	√	X	X
Non-fuel commodity prices	√√√	X	X	X	X
Fuel price	√√√	X	√	√	X
Other current account shocks (e.g., remittances, transfers)	√	X	√√	X	X
Public ST rollover	√√√	√√√	√√√	√√√	√√√
Private ST rollover	√√√	√√√	√√√	√√√	√√√
Public MLT rollover	√√√	√√√	√√√	√√√	√√√
Private MLT rollover	√√√	√√√	√√√	√√√	√√√

Source: Various IMF Staff Reports.

1/ The number of √ indicates the overall frequency in the description of one country's FCL/PLL arrangement scenarios. Implicit assumptions without clear description are not counted.

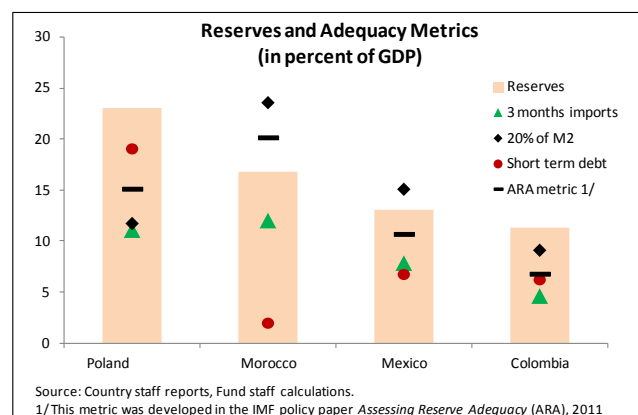
2/ X marks that the item never appears in one country's FCL/PLL arrangement scenarios.

**50. Moreover, a more country-specific focus could be achieved by placing greater emphasis on those factors that are particularly relevant for the circumstances of a specific country.** First, in addition to the eight external variables considered in the historical distributions in the current framework (Figures 2a-3), there are other variables that could be important determinants of access levels for certain countries. For example, remittances are an important income item for Mexico and Colombia. While the shock assumptions on remittances are based on Mexico's and Colombia's own experiences in the past, they could also be compared to the experiences of other large recipients of remittances from similar source countries. Another such variable is resident deposit outflows—again assumptions on this could be compared with the experiences of other countries with similarly open capital accounts. Second, within the broad categories of public and private MLT and ST debt rollover rates, there are some sub-categories that may face larger risks than others. For example, Mexico and Poland both have highly developed local-currency denominated sovereign debt markets and a sizeable portion of this debt is held by non-residents. This part of the external debt could be more volatile than FX denominated sovereign external debt under a stress event, and hence differential rollover rates could be considered under an adverse scenario (this has already been done in the most recent FCL arrangement for Mexico). Another example is to distinguish between financial sector and non-financial sector external debt, which could be subject

to different risks, and hence could have different assumptions (the latest FCL arrangement for Poland makes the distinction).

### 51. At the same time, the treatment of reserves could be more standardized in access

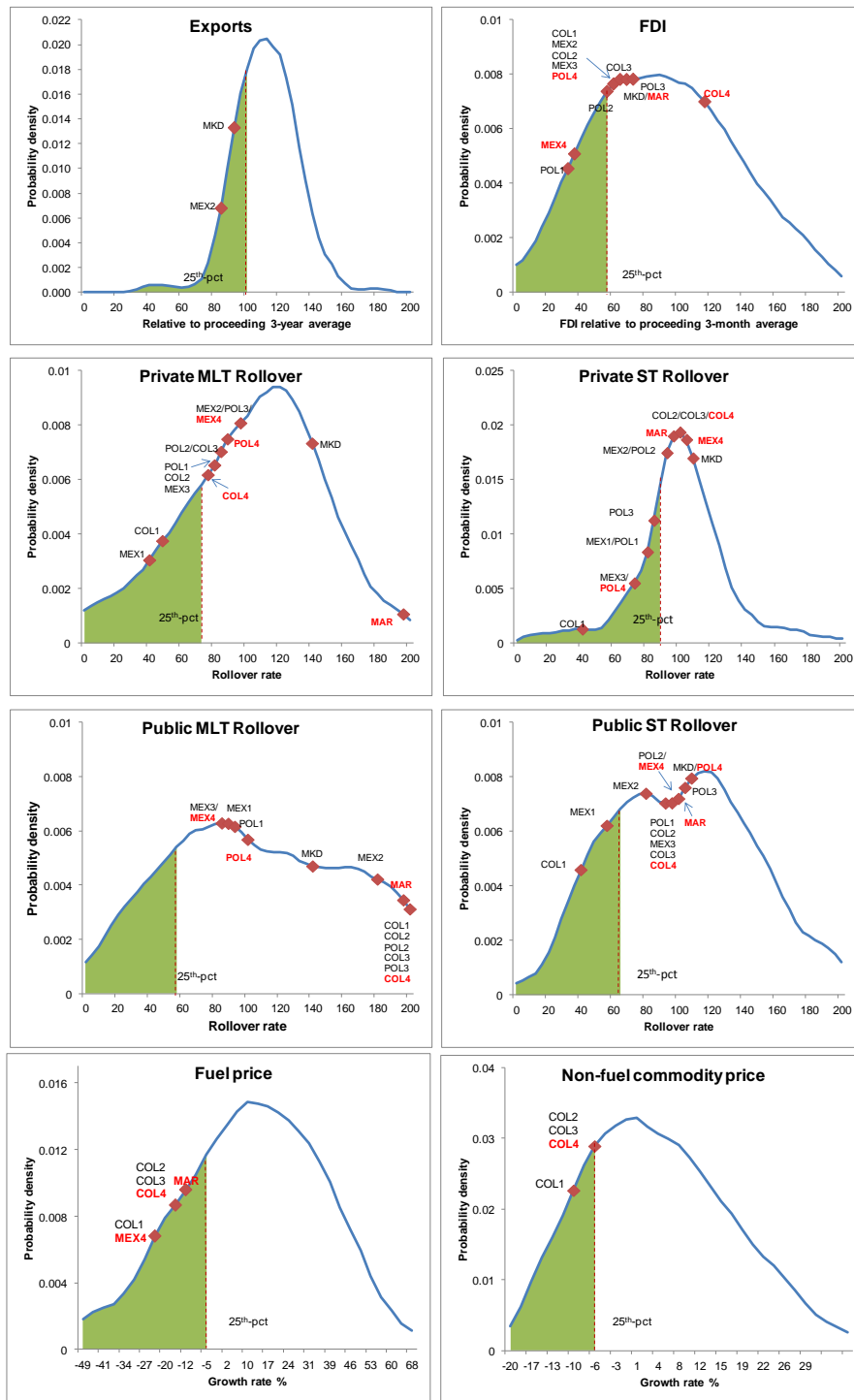
**discussions.** The FCL guidance note states “for countries for which reserve levels are plentiful, and well above adequate, *staff may want to consider the use of international reserves to cover part of the financing gap under the adverse scenario, implying lower access under the FCL arrangement*” (emphasis added). Relatedly, the 2011 Review of the FCL and PCL suggested that the minimum reserve adequacy anchor under the



adverse scenario could go down to some “lower bound,” based on a relevant reserve metric, given that reserve adequacy is a key part of qualification. By contrast, the assumptions on reserve use under the scenarios underpinning access have differed widely, and in the FCL cases no use of reserves has been assumed. The 2012 FCL arrangement for Mexico and the 2013 FCL arrangement for Colombia assume no reserve accumulation, and the 2013 FCL arrangement for Poland assumes a reserve accumulation half of that projected under the baseline scenario, while the 2012 PLL arrangement for Morocco assumes a drawdown of reserves to 85 percent of the Fund’s reserve adequacy metric. One possibility to more firmly anchor the reserve assumptions in adverse scenarios is to consider a lower bound on the level of reserve adequacy based on crisis prediction thresholds.<sup>20</sup> This could be elaborated in the FCL and PLL guidance notes.

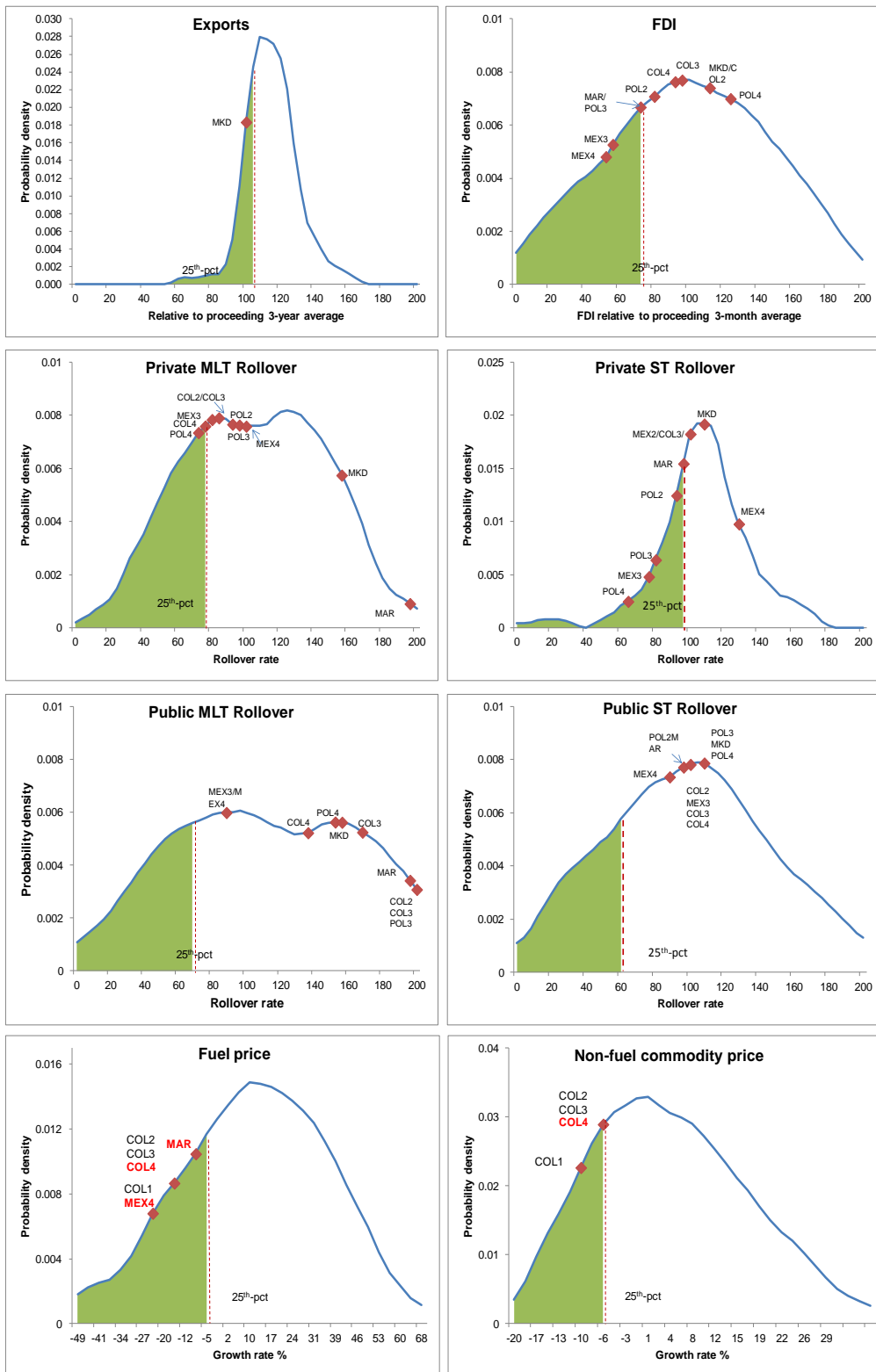
<sup>20</sup> For the metric developed in *Assessing Reserve Adequacy*, the relevant threshold which minimizes the type I and type II prediction errors is 80 percent.

Figure 2a. Empirical Adverse Shock Distribution in Crisis Year<sup>1</sup>

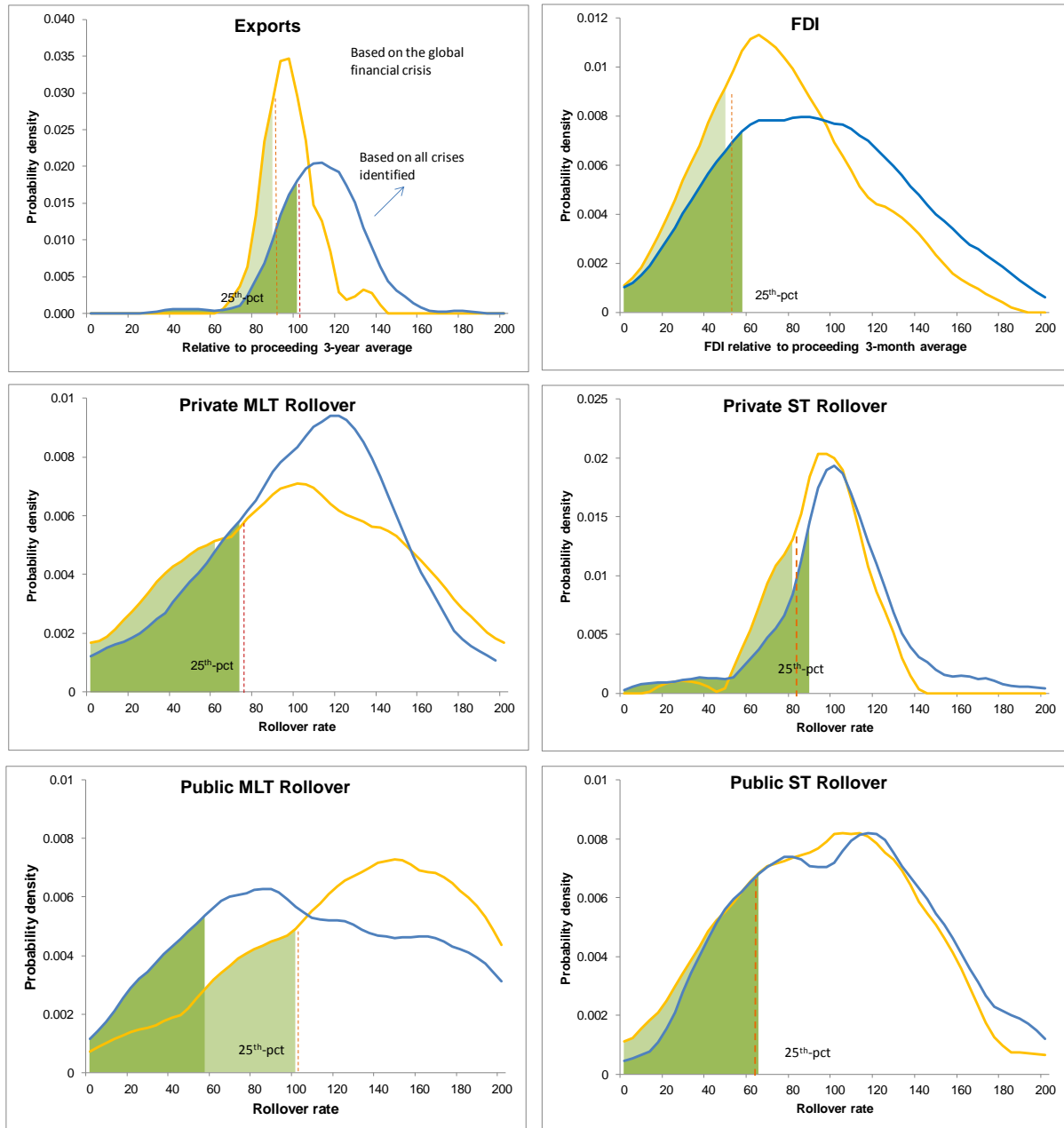


1/ In the empirical distributions, “shocks” are defined as countries’ actual experiences during the crisis year (for all four types of debt rollover rates), or countries’ experiences during the crisis year relative to preceding 3-year average (for exports and FDI). This definition can be different from that in the FCL/PLL staff reports, which often define shocks as deviations in the adverse scenario from the baseline projection. In placing the shock assumptions underpinning the FCL/PLL arrangements on the empirical distributions, staff recalculates the FCL/PLL shock assumptions so that the definition of shocks is in line with that underlying the empirical distributions.

**Figure 2b. Empirical Adverse Shock Distribution One Year After The Crisis**



**Figure 3. Empirical Adverse Shock Distribution: All Crisis Years and the Global Financial Crisis**

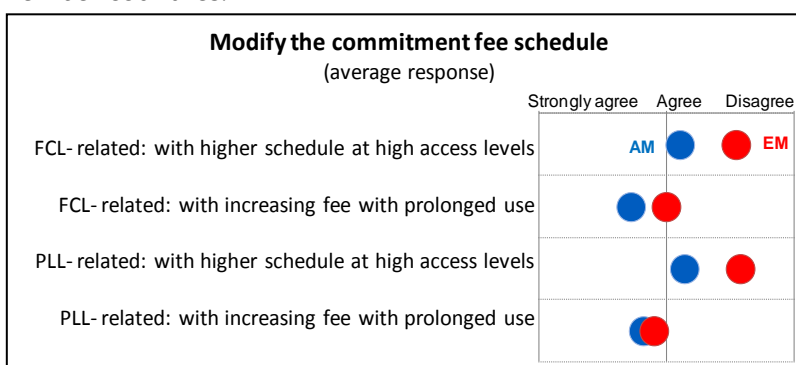


**52. There is no general necessity to build reserves as part of the exit process.** Exit (through declining access) should come as external risks subside, likely leaving reserves at an appropriate level of adequacy given the requirements of qualification. For countries with a low level of reserve adequacy, there may be a need to increase reserve holdings but this is not related to exit.

### C. Commitment Fees

**53. Commitment fees can potentially affect a member’s incentive to exit a precautionary arrangement.** The rationale for charging a commitment fee for contingent credits is to compensate the Fund for the cost of establishing and monitoring precautionary arrangements and for setting aside resources to be used when a purchase is made. The current upwardly-sloping fee structure was introduced as part of the broader reforms in 2009, including the creation of the FCL, with the aim of discouraging unnecessarily high precautionary access and thereby helping to contain risks to the Fund’s liquidity (Box 6).<sup>21</sup> Exit issues were not a major focus of the discussions at that time. However, prolonged commitment of Fund resources may not be consistent with the purpose of the FCL (and also the PLL) as providing a temporary supplement to reserves in periods of heightened stress. More generally, prolonged commitments could undermine the revolving nature of the Fund’s limited resources.

**54. As discussed earlier, evidence is mixed as to whether timely exit from FCL arrangements is an issue.** On the one hand, concerns about timely exit in the context of FCL arrangements have been raised repeatedly by many Executive Directors. Moreover, survey responses identify this as a key concern among the membership (see text table). On the other hand, the staff’s analysis suggests that the repeated use and high access under the FCL typically took place in an environment of heightened global risks that have not abated, especially since the second FCL requests of these member countries.



**55. To the extent that timely exit from a precautionary arrangement is considered an issue, time-based commitment fees could potentially have a role to play.** While risk and access assessments by the Board play the primary role in ensuring timely exit, a strengthening of

<sup>21</sup> Since 2009, commitment fees are 15 bp for access up to 200 percent of quota, 30 bp for access between 200 and 1,000 percent of quota, and 60 bp above 1,000 percent of quota. The fees are refundable on amounts purchased during a 12-month period on a pro-rata basis.

price-based incentives could in principle complement this role. The approval of any change in the commitment fees would require a 70 percent majority of the Board's total voting power.

**56. Time-based commitment fees would need to be carefully designed to avoid unintended adverse effects.**

- Given the debates on whether continued support under the FCL was justified, and the presumption that the FCL should not become a permanent source of funding, a time-based element could be introduced to increase incentives for members to exit their reliance on the FCL over time. This would need to balance the goal of providing a meaningful incentive for reducing access and/or exit over time, while not unduly discouraging extended use when warranted by country circumstances and global risks.
- Judgments would need to be made about the appropriate level of a time-based element. One possible benchmark is the marginal cost of accumulating reserves for emerging market countries. Figure 4 plots the adjusted composite EMBI and its 25<sup>th</sup> percentile<sup>22</sup> which could be used to approximate these costs for emerging market countries and countries that might qualify for the FCL, respectively. This suggests a long-run marginal cost of accumulating reserves for the latter group, i.e., the most credit worthy EMs of around 300 basis points. Current commitment fees are clearly well below this cost (and the gap is even larger for less credit worthy members), but that would seem appropriate given that they represent a fee for a line of credit rather than the cost of an actual drawing. Current commitment fees are also lower than such fees applied by other IFIs (see Table 2), and some of these institutions commit resources only for shorter periods of time and none of them refund the commitment fee in case of drawing.
- Commitment fees apply across all GRA arrangements. Given the legal requirements of uniformity in charges, the time-based increase in the commitment fee would then apply to any arrangement in the credit tranches (and not just to FCL) approved in the future.<sup>23</sup> Since limited concerns have been expressed about repeat commitments of Fund resources under precautionary arrangements outside the case of high access FCL arrangements,<sup>24</sup> consideration could be given to an alternative of redesigning the FCL as a special policy outside the credit tranches with special commitment fees applying only to this policy (repeat use has not been an issue for the PLL, so it would not be subject to the time-based fee in this case). However, the

<sup>22</sup> The 25<sup>th</sup> percentile of the adjusted composite EMBI, a widely-used emerging market bond index, provides a rough approximation for the set of members that are potential FCL qualifiers. This metric has also been used to reflect the most credit worthy members in the context of reviewing the basic margin and surcharges (e.g., [GRA Lending Toolkit and Conditionality - Reform Proposals](#) and [A New Rule for Setting the Margin for the Basic Rate of Charge](#)).

<sup>23</sup> The commitment fee is a form of charge under the Articles and, as such, is required to be uniform for all members (Article V, Section 8(d)). Differentiation of charges has been limited to relevant differences in member's use of the Fund's resources (e.g., having a different balance of payments need as addressed by a special facility).

<sup>24</sup> Not only are access levels considerably smaller in precautionary SBAs—since 2002, only 4 precautionary SBAs have had average annual access above 200 percent of quota—they have generally not been renewed sequentially more than once. The recently approved third successive Romania arrangement is an exception, and ahead of the request some Directors raised questions about the appropriateness of a new program.

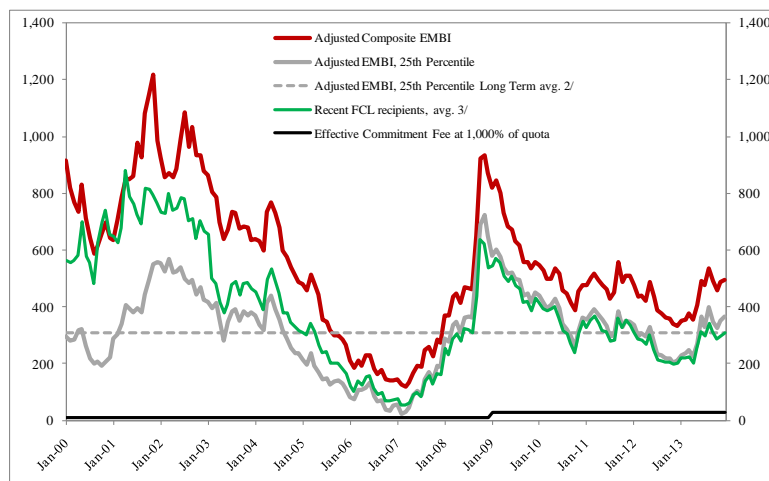


rationale for a time-based commitment fee, i.e., to strengthen price-based exit incentives, applies in principle across all commitments made by the Fund, not just those under the FCL. Accordingly, staff's preliminary view is that, if a change were to be made, the time-based commitment fee would apply across all arrangements in the credit tranches as well as Extended Arrangements. In any event, when designing this specific policy, the ramifications for arrangements other than FCL arrangements would need to be taken into account.

**57. A time-based fee element would raise a number of complex policy and operational issues.** Among others, these include:

- **The duration that triggers the time-based element (the “clock”).** One option is to link the duration triggering a time-based element to the typical length of a severe shock (i.e., some 3–4 years).<sup>25</sup> For example, for members that receive support, but do not draw, under an FCL arrangement approved for the maximum 2-year duration, this element would set in around the mid-point of the first successor or at the beginning of the second successor FCL. Alternatively, the time-based element could be modeled on the Fund's “prolonged use” framework, applying to cases where a member has had in place arrangements and drawings became available but did not take place for say at least three years within a five-year period. Other options could also be explored.

**Figure 4. Marginal Cost of Reserves: Adjusted EMBI, 25<sup>th</sup> Percentile, and FCL Recipients<sup>1</sup>**  
(In basis points)



Source: Bloomberg.

1/ The adjusted EMBI comprises the five year US dollar EMBI spread adjusted by adding the spread between 3 month Treasury bills and 5 year Treasury bonds to account for the lower maturity of reserve portfolios

2/ The average of the adjusted EMBI 25 percentile curve for the entire period, excluding 10 percent of the highest and lowest observations

3/ For Poland the five 5 year euro EMBI spread is used

<sup>25</sup> See, for example, Dias and Richmond (2007); Mecagni, Atoyan, Hofman, and Tzanninis (2007); and Hatchondo and Martinez (2013). Making the clock conditional on global or country-specific risk abatement assessments would raise important operational issues and signaling concerns.

- **The length of the “cooling-off” period between arrangements before the “clock” resets.** The rationale of helping to ensure timely and durable exit suggests that short gaps (say of up to 6-months) between arrangements should not prevent the application of time-based elements.
- **The refund mechanism in the case of drawing.** As noted, commitment fees under the current regime are refunded in the case of drawings. If an additional time-based fee were introduced, one option would be to maintain a uniform treatment for all elements of the fee and apply the refund mechanism also to the time-based element. Alternatively, the time-based component of the fee could be non-refundable, with the latter potentially strengthening the incentive for lower access and exit.

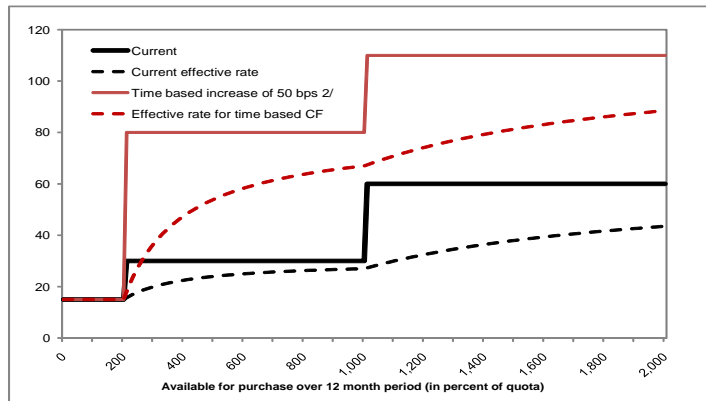
**58. Illustrative commitment fee structures involving the use of a time-based element are shown in Figure 5.** The two purely illustrative examples aim to contain the potentially adverse spillover effects noted above:

- Panel (a) presents a uniform time-based charge of 50 basis points, applying to levels of access above 200 percent of quota;
- Panel (b) shows the case where commitment fees double at each level of access when the time-based charge becomes effective.

The first option would provide a stronger exit incentive for all access levels above 200 percent of quota. It would represent a more than doubling of the current effective commitment fee for access of around 1,000 percent of quota once the time-based element is triggered. Given that the average annual access for precautionary SBAs in the period 2002-2013 was about 80 percent of quota, raising the commitment fee for access levels in excess of 200 percent of quota, as in this option, would generally have left these arrangements unaffected. The second option would raise the commitment fee for all arrangements but only marginally in absolute terms for very-low access cases. Given the automaticity of a time-based element, a lower effective increase would help mitigate cost increases for members who require extended insurance but nevertheless trigger the mechanism. That said, the effective commitment fee rate even under illustrative option (a) would still be broadly in line with the rate charged by other IFIs, with only the IMF reimbursing of such fees when drawings are made. As noted above, these calculations are purely illustrative and are based on the current access thresholds. The thresholds would need to be reconsidered, along with the Fund’s policies on access and surcharges that would apply, following the effectiveness of the quota increases under the 14<sup>th</sup> General Review of Quotas when members’ quotas double on average.

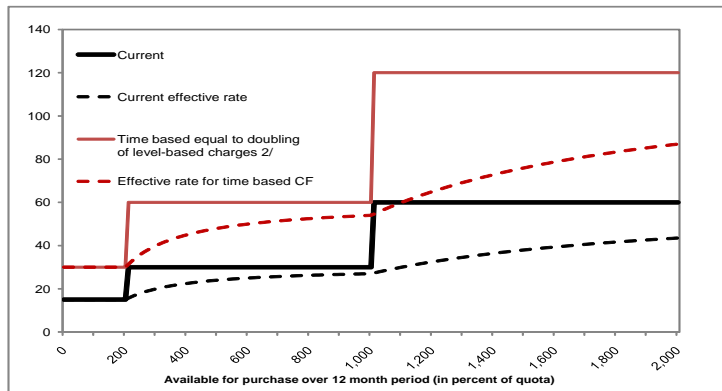
**Figure 5. Time Based Commitment Fees: Illustrative Scenarios<sup>1</sup>**

A. *No change for access under 200 percent of quota and higher fees for higher levels of access*



1/The effective rate is the total commitment fee payable relative to total access available for purchase over a 12-month period.  
2/ Time based fees are levied for access higher than 200 percent of quota and add 50 bp to level based fees.

B. *Doubling the level based thresholds*



1/The effective rate is the total commitment fee payable relative to total access available for purchase over a 12-month period.  
2/ Time based fees are doubled to 30, 60 and 120 basis points while maintaining the same quota based thresholds.

**Table 2. Commitment Fee Charged by Other IFIs<sup>1</sup>**

<b>Institution</b>	<b>Fee</b>	<b>Description</b>
<i>ADB (Asian Development Bank)</i>	15 - 75 bps	Fee for mainstream LIBOR-based loan is 15 bps; fee for counter-cyclical and special policy loans is 75 bps
<i>AfDB (African Development Bank)</i>	25 - 75 bps	Time dependent graduated commitment fee for policy based loans
<i>EBRD (European Bank for Reconstruction and Development)</i>	50 bps	Accrues 60 days after signing but only becomes payable after the loan has been declared effective
<i>IBRD (International Bank for Reconstruction and Development)</i>	50 bps	Fee on undisbursed balances under Deferred Drawdown Option (DDO)
<i>IDB (Inter-American Development Bank)</i>	25 - 85 bps	Charge for regular loans is 25 bps; fee for contingent credit lines ranges from 50 bps to 85 bps

1/ Commitment fees by other IFIs are not refunded upon drawing.

## D. Exit Stigma

**59. An ongoing concern for FCL users is that there may be stigma associated with exit, or even with reducing access across arrangements.** In particular, these members are concerned about a possible market reaction to any change in the level of coverage. This concern may stem partly from the fact that no country has exited from the FCL, and hence the market reaction is uncertain, although Colombia did reduce its request for access between its first and second FCL arrangements. In any event, the answer would seem to lie in effective communications, starting with more detailed discussions of exit plans and strategy in request and review documents. While all the requests for FCL arrangements since the 2011 FCL review have added discussions on exit strategy, they would seem to be less than the standard set forth in the guidance note in two respects: (i) the absence of a justification for the duration (or more broadly the expected duration of the use of the FCL) based on risk evolution; and (ii) the discord, noted above, between the extent of external risk and the magnitude of the shocks assumed. The increased transparency coming from a more explicit elaboration of exit strategy would reduce the likelihood of market surprises following subsequent changes in access, or even exit.

## E. Access Caps

**60. Access caps apply to PLL arrangements but not FCL arrangements.** For one-to-two year PLL arrangements, access is capped at 500 percent of quota in the first year, and at a maximum of 1,000 percent of quota under the arrangement, while for six-month PLL arrangements, access is limited to 250 percent of quota (although this can be raised to 500 percent in exceptional circumstances). At this time, staff sees no need to change these caps. Aside from FCL arrangements, precautionary Fund arrangements, including the two PCL/PLL arrangements, have always been below these thresholds suggesting little need or appetite for an increase.

## F. Possible Reform Proposals

61. Staff proposes the following:

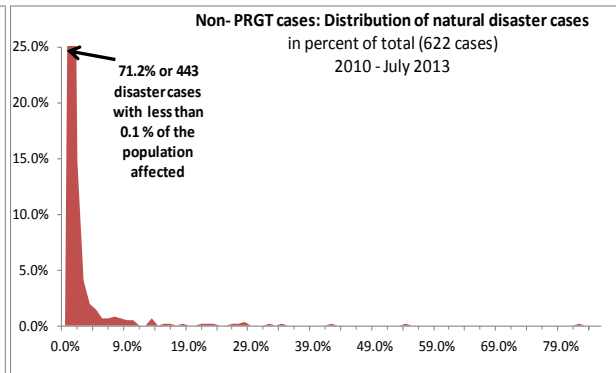
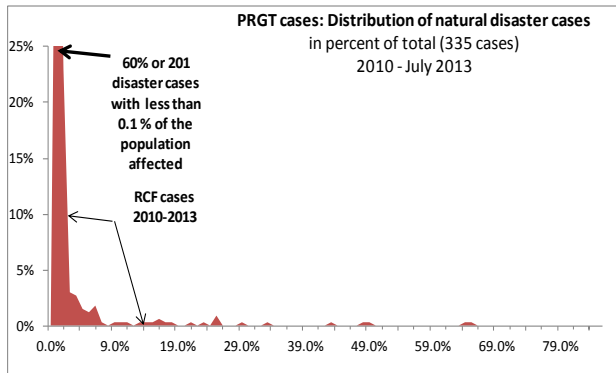
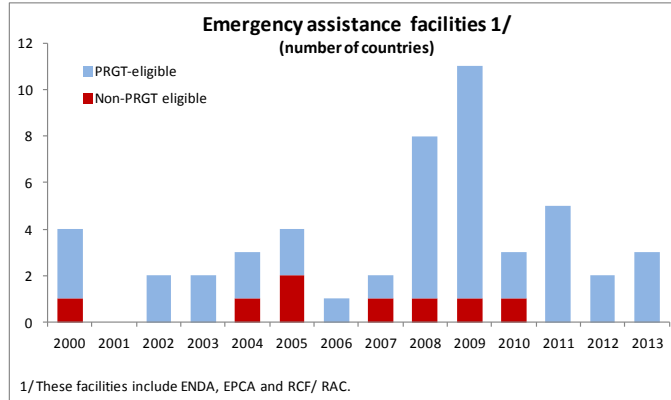
- **External risks.** Staff proposes the development and use of a new external economic stress index focused on areas of external vulnerability identified by country teams, which would help anchor judgments underpinning exit and access in both FCL and PLL arrangements. The index presented in the sub-section above is only illustrative; details would need to be worked out in the context of the operational guidance note.
- **Increased transparency.** While there has been an improvement in the transparency of access discussions in staff reports for FCL and PLL arrangements, there is scope for further strengthening. Linking the specific level of measured external risk—as indicated by the external economic stress index—to the severity of the shocks assumed in adverse scenarios (as indicated in Figure 1) could help in this regard, although ultimately decisions will continue to rely on judgment. Staff also recommends anchoring reserve assumptions in adverse scenarios to a level consistent with reserve adequacy guidelines.
- **Commitment fees.** A time-based element could be added to the commitment fee structure to provide price-based incentives for timely exit. Its design would need to be calibrated carefully to avoid adverse incentive effects, including for Fund financing instruments other than the FCL.

## RAPID FINANCING INSTRUMENT

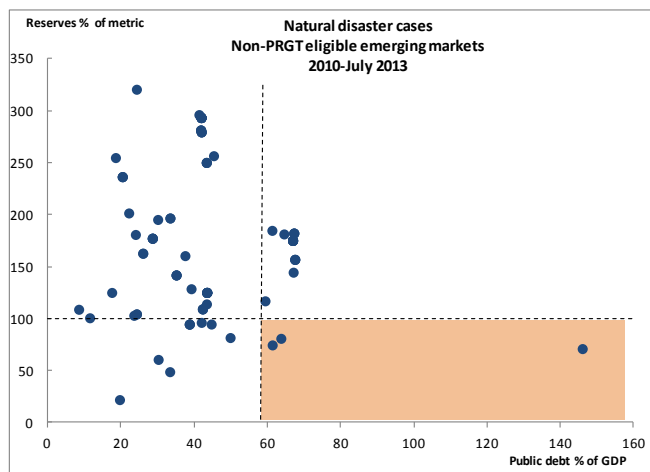
62. **The RFI was established in response to a call for an enhanced and more flexible instrument for urgent balance of payments needs**, partly in the context of the political transformation in the Middle East and North Africa (MENA) region. Modeled closely on the Rapid Credit Facility (RCF) for low-income countries, the RFI was intended to fill a gap in the GRA lending toolkit to provide emergency assistance to countries facing a broader range of urgent balance of payments need, including from fragile situations and term-of-trade shocks.<sup>26</sup> The RFI is available to all members, but given that PRGT-eligible members may use the concessional RCF, it is more likely to be of interest to non-PRGT members. Assuming that the financing needs of some non-PRGT eligible countries in such situations were small or temporary, the RFI was expected to serve a catalytic role (i.e., Fund financing induces other creditors/donors to extend financing) and to work as a bridge to meet their immediate financing needs, as the authorities finalize work on an upper credit tranche (UCT)-quality program to be supported by a Fund arrangement (typically an SBA) and/or look for donor/creditor financing.

<sup>26</sup> The RFI replaced the previous instruments for emergency assistance for natural disasters and for post-conflict situations.

**63. Since its inception in 2011, there have been no requests for financing under the RFI.** Emergency assistance instruments in general have been used infrequently. Since 2010 there have been only 13 cases, and an overwhelming majority of them have been for low-income countries (see chart).<sup>27</sup> Amongst EMs, purchases since 2001 under emergency assistance instruments were made only by a few Middle East countries (Iraq (2004), Lebanon (2007 and 2008), and Pakistan (2010)) and some small island countries (Maldives (2005), Sri Lanka (2005), and St. Kitts and Nevis (2009)). This marked difference relative to LIC usage of the RCF does not appear to stem from a greater prevalence of natural disasters in LICs, as the chart below shows.



**64. Evidence suggests that many non-PRGT countries had sufficient fiscal and external buffers.** As the shaded region in the adjacent scatter plot demonstrates, very few of the countries that experienced a natural disaster did not either have sufficient external buffers—reserves greater than 100 percent of the ARA metric—or sufficient fiscal space—public debt less than 60 percent. The two countries that had insufficient buffers (Pakistan and Jamaica) were both either in negotiations or had Fund-supported programs. There is also little

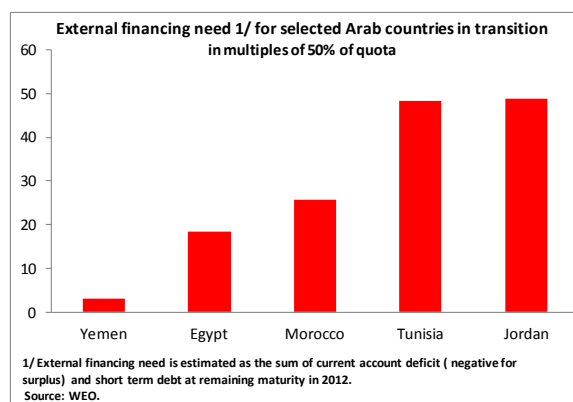


<sup>27</sup> Similarly, since 2007, of the 34 cases of emergency assistance, only four are to non-PRGT eligible members.

evidence to suggest that these countries sought alternative sources of external financing from the IBRD, though, some countries did access the Global Facility for Disaster Reduction and Recovery, a trust fund managed by the World Bank

**65. Interviews with staff and results from country surveys also reveal that the primary reason the RFI was not used in the context of the political transformation in the MENA region was the low level of access.**

The text chart compares external financing needs for selected Arab Countries in Transition (ACTs) as a percentage of the annual limit for the RFI (50% of quota). The chart shows that Yemen is the only ACT country for which RFI support could have made a material contribution to its financing



need, and since Yemen is PRGT-eligible, its disbursement was made under the RCF. Potential financing needs are twenty times RFI access limits for Egypt and upward of fifty times the access limit for Jordan. This also demonstrates that a small change to the access limit is unlikely to have had a significant impact on demand for the RFI. The interviews also suggested that because the RFI does not require UCT-quality policies or provide a framework for adjustment with ex-post conditionality and reviews, it is unlikely to play a catalytic role for other sources of financing.

**66. Notwithstanding the limitations outlined above, the RFI may still fill a critical gap in the GRA toolkit.** In the absence of Emergency Natural Disaster Assistance (ENDA) and Emergency Post-Conflict Assistance (EPCA), member countries facing urgent BOP needs arising from exogenous shocks, post-conflict situations, or other disruptive events, may still find the RFI useful, particularly if they are not yet able to develop a UCT-quality program. Emergency assistance can also be used by a member with a Fund arrangement but whose program was off track (Pakistan requested ENDA in 2010), and can alleviate the financial burden on the PRGT through blended assistance to graduating low-income countries (as St. Lucia requested RCF-ENDA assistance in 2011), particularly if the financing need is relatively small. As regards the catalytic role, one option could be to combine RFI support with a SMP that could serve both to establish a track record toward a UCT-quality program and as the basis for parallel creditor or donor support.<sup>28</sup> If official creditors were willing, the Fund could also propose that the SMP be used as the basis for a multi-donor trust fund.<sup>29</sup>

**67. Despite limited use to date, the RFI is a potentially useful instrument and staff proposes retaining it and maintaining the current access limit.** In view of the absence of UCT-quality conditionality on RFI resources, and the size of financing needs in ACT countries—small

<sup>28</sup> The possible use of SMPs for this purpose was envisaged at the time of the establishment of the RFI. See [The Fund's Financing Role—Reform Proposals on Liquidity and Emergency Assistance](#), IMF Policy paper, October 28, 2011.

<sup>29</sup> A similar proposal was made in the last [Board paper on fragile states](#).

changes are unlikely to have an impact—staff proposes to keep the current access limit in line with the need to safeguard Fund resources.

## OTHER ISSUES

### A. Forward Commitment Capacity

**68. Precautionary arrangements, including under the FCL and PLL, tie up Fund resources and reduce the Fund's forward commitment capacity (FCC).** The one year FCC is the Fund's key indicator of its liquidity position. In place since 2002, it provides a single, transparent measure (derived from published data) of the amount of resources that the Fund has available to extend new commitments to its members at any point in time. The FCC does not distinguish between drawing and precautionary arrangements, despite the historical experience that suggests the probability of drawing under the latter is substantially lower. Accordingly, the question has been raised by some Directors as to whether commitments under precautionary arrangements should be treated at less than full face value when calculating the FCC.

**69. The main benefit of treating precautionary arrangements at less than full value in the FCC would be to free up resources currently committed to precautionary arrangements for lending to other members.** The Fund's overall resource envelope would not be increased, but it would signal a willingness to commit more than this total envelope on the grounds that the probability of all precautionary commitments being drawn is relatively low. Other things equal, this would raise the FCC for the same resource envelope. The impact on the FCC would depend on the size of the precautionary arrangements and the probability assigned to their being drawn. For example, current commitments under precautionary arrangements amount to around SDR 79 billion. If a uniform probability of, say, 50 percent was assigned to their being drawn, the current FCC would rise from some SDR 270 billion to about SDR 310 billion. The impact would be larger, the lower the assigned probability.

**70. This potential benefit needs to be weighed against a number of important drawbacks:**

- A key concern is that the Fund could find itself in a position where it cannot meet all its commitments. Unlike most central banks, which are able to create domestic currency, the Fund cannot mobilize new resources at short notice. While it is permitted to borrow temporarily to replenish quota resources, arranging such borrowing takes time and its availability is not assured. In contrast, members can draw very large commitments under FCL arrangements and PLL arrangements, possibly on a few days notice. Thus, unless contingent access to additional borrowing by the Fund was arranged in advance, a practice of partial scoring of precautionary arrangements would expose the Fund to the risk that these resources could be largely or fully drawn down and the Fund would be unable to meet all its existing loan commitments to other members or to help new members facing balance of payments difficulties.
- Unlike other financial institutions, the Fund typically faces highly concentrated exposures and cannot diversify related liquidity risks. In today's integrated world, the circumstances where one



member with an FCL arrangement would need to make a purchase under its arrangement would likely involve a generalized global financial shock affecting a wide range of members, including those with similarly strong fundamentals. The Fund does not have the ability to diversify its risks with a view to reducing the probability of multiple requests for drawings at the same time. The concentrated nature of Fund exposures therefore undermines the rationale for holding resources to cover only part of its commitments.

- Such a change could also reduce the transparency of the FCC and introduce an element of judgment, with potentially undesirably signaling effects. An important strength of the current measure is that it can be readily derived from existing published data on the Fund's financial position and does not involve judgment. If precautionary arrangements were scored only partially under the FCC, staff would need to assign probabilities to the likelihood of drawings under such arrangements. This could be done on an individual country basis, which would reduce transparency and could have adverse signaling effects given that the probabilities would be expected to change over time in light of global or individual country developments. An alternative would be to assign a single probability to all or a particular type of arrangement. However, this single probability measure would inevitably be somewhat arbitrary and would not reflect actual probabilities in individual cases. A further implication of such an approach is that the FCC could change significantly with no action from the Fund if, for example, a large purchase was made under an FCL arrangement, thereby reducing its transparency.
- If the Fund were to consider such a change, it would also be necessary to reassess the size of the prudential balance. The prudential balance would need to provide a buffer against unexpected drawings under precautionary arrangements in addition to its current purposes of protecting against the risk of members dropping out of the FTP and/or seeking to encash their reserve tranche positions. Thus, the net impact on the FCC would likely be reduced.

**71. Given these concerns, staff believes that the current practice of full scoring of precautionary arrangements in the FCC remains appropriate.** In this context, it should be stressed that the current practice has not prevented the Fund from supporting members with balance of payments needs, even during the height of the global crisis; and staff's analysis suggests that this continues to apply in most adverse scenarios, taking into account also the resources from the 2012 borrowing agreements. Moreover, while the FCC provides an important guide to the membership and markets about the adequacy of Fund resources, it is not a binding constraint on the Fund's ability to commit new resources. The Fund retains flexibility to commit resources based on an overall assessment of its liquidity position, and could for example decide to temporarily reduce the prudential balance in order to meet unexpected needs, possibly as a bridge to mobilizing additional resources.

## B. Article IV Consultations

**72. Timing problems have arisen with some recent reviews under FCL and PLL arrangements.** The FCL decision states that "a very positive assessment of the member's policies by the Executive Board in the context of the most recent Article IV consultations" is part of the

requirements for qualification to be assessed at the time of a new arrangement or during a review. A similar requirement exists for the PLL, except the standard is for a “generally positive” assessment. Some recent reviews under FCL and PLL arrangements have had Board assessments under Article IV consultations very closely timed with the reviews, preventing the Board’s assessment from being fully integrated into the assessment of qualification in staff documents on reviews under these arrangements. Such a practice could prove particularly problematic in cases where a qualification decision was finely balanced. The FCL and PLL operational guidance notes will be amended to clarify the need to have the very/generally positive Board assessment in time before going to the Board to discuss qualifications so as to influence the preparation by staff of the review paper

### C. Next Review

**73. It is proposed that the next review of the FCL, the PLL, and the RFI will take place on an as needed basis.** This will allow the timing of the next review to be based on experience with the instruments.

## ISSUES FOR DISCUSSION

- Directors may wish to comment on possible reforms related to the **Global Financial Safety Net** and Fund stigma set out in paragraphs 19-21. Do Directors see scope for a follow-up Board paper on alternative modalities for engagement with other actors who contribute to the GFSN?
- With respect to the **qualification**:
  - Would unifying the FCL and PLL qualification areas help facilitate more predictability in the PLL qualification assessment?
  - Would the development and use of indicators of institutional strengths help improve the predictability of qualification assessment?
- Do Directors agree that the PLL should remain in the Fund’s lending toolkit for now, despite its limited use and the stigma resulting from the tiering within the Fund’s lending toolkit?
- Would the inclusion of a new external economic stress index in future FCL and PLL documents be helpful to inform discussions of access?
- Do Directors agree with the proposal to strengthen transparency in access discussions in FCL and PLL arrangements?
- Are changes to **commitment fees** aimed at affecting exit incentives for precautionary arrangements desirable? If so, should a time-based element be added to such fees?
- Do Directors agree that full scoring of precautionary arrangements in the **FCC** remains appropriate?
- Do Directors agree that there is no need to change the design of the **RFI** at this point?
- Do Directors agree that the next review of the FCL, the PLL and the RFI be conducted on an as needed basis?

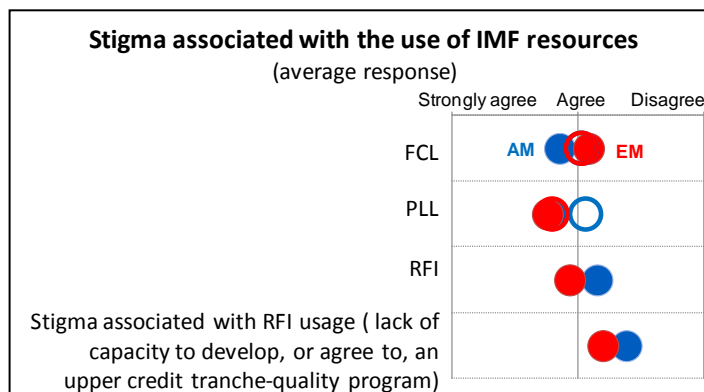
### Box 1. Changing Perspectives on Fund Engagement<sup>1</sup>

**Stigma represents the reluctance by some members to engage the Fund for policy advice and financing.** The historical relationship with the Fund has constrained the demand for the services provided by the Fund in part of the membership. A recent IEO report notes that stigma has a strong regional dimension: it remains particularly strong in emerging markets in Asia and Latin America, in view of the bitter experience from the crises in the late 1990s and early 2000s.<sup>2</sup>

**Recent survey results point to encouraging signs that the negative perception of the Fund may be declining among policy makers.** Stakeholder surveys commissioned by COM suggest that the perception about the Fund in many countries, particularly in Asia, has shifted from negative to neutral. In particular, central bank and finance ministry officials now report appreciating the Fund’s role in providing global, cross-country perspectives in surveillance, including analyses of global imbalances and spillover effects, and high-quality technical assistance. They also report high regard for the Fund’s pragmatic approach since the crisis, which is seen as more flexible than before. Country authorities qualified these favorable views, however, noting that they do not generally reflect public opinion.

**Nonetheless, stigma seems as entrenched as ever in the public’s perception of past Fund engagement, and hence policymakers remain reluctant to request Fund financing.** Negative perceptions appear to linger strongly among the general public, media, and NGOs. The views of think tanks and academia vary, depending on their direct exposure to the Fund. While some see evidence that the Fund has learned from the experience of past crises, many in emerging markets and developing economies associate the Fund’s large-scale support to European members with a lack of evenhandedness.

The survey undertaken for this paper also **suggests an ongoing stigma issue**, even for its instruments with lighter ex post conditionality. Most respondents believe that Fund-related stigma remains a factor inhibiting the use of both the FCL and PLL, although this view is slightly stronger for the PLL. Views have changed little since the survey for the last review.



1/ This box was prepared by Toshiyuki Miyoshi (SPR).

2/ IMF Independent Evaluation Office, 2013, *The Role of the IMF as Trusted Advisor*.

## Box 2. Impact of the FCL and PLL on Sovereign Spreads and Bond Flows<sup>1</sup>

To investigate the impact of an FCL arrangement on spreads and bond flows, we estimate panel regressions for the group of all FCL users and for countries considered by the investment community as FCL qualifiers. These countries' EMBI spreads and EPFR bond flows were regressed on their lagged values, average spreads or total flows of their regional peers, global market volatility as captured by VIX, reserves, real growth and public debt-to-GDP ratios and current account balances. In all regressions, a dummy was included that equaled one for dates when the country was an FCL and zero otherwise. For the presumed qualifiers, the earliest FCL date (of Mexico) was used as an indication of actual availability of the arrangement.<sup>2</sup>

The results suggest FCL eligible members tend to have higher debt capital inflows as well as lower spreads, suggesting reduced risk premia (see text table). The decrease in spreads is large at over 30 basis points when the impact is evaluated for the three FCL users (the result is not statistically significant possibly due to the rise in Polish spreads during late 2011 when the Eurozone crisis deteriorated<sup>3</sup>). The decrease is even larger and statistically significant in a regression for Colombia and Mexico. The statistically significant rise in debt capital inflows of over 0.5 percent of stock (fourth column) confirms the positive impact of the arrangement on the three FCL countries. The table also shows that the set of presumed FCL qualifiers, as perceived by the markets, also benefit from the mere existence of the FCL instrument. The countries' risk premium fell on average by over 12 basis points and debt capital flows increased by almost 0.4 percent of stock—less than the impact for actual FCL users. A similar result holds for the whole group of 9 FCL (actual and presumed) users and qualifiers, with the spread decrease statistically significant in this case. In the case of Morocco, the PLL arrangement also seems to have decreased the country's spreads, although the result is not statistically significant.

### Regressions show FCL reduced EMBI spreads, raised bond flows in both FCL/PLL and possible qualifying countries\*

	EMBI spreads					EPFR bond flows		
	FCL	COL & MEX	FCL+	FCL & FCL+	MAR	FCL	FCL+	FCL & FCL+
FCL/PLL dummy	-31.36	-51.27***	-12.46	-15.28**	-5.699	0.501**	0.382***	0.411***
Lag 1	0.523**	0.326**	0.772***	0.737***	0.623***	0.330***	0.367***	0.380***
VIX	1.826*	2.604	2.266**	2.213***	1.876***	-0.0199**	-0.0176***	-0.0175***
Comparators	0.201**	0.221*	0.0102	0.0384	0.0621*	-0.000106	0.000331	0.000113
Growth	-0.148	-1.638	0.768	0.777	5.793	-0.00998	0.0324*	-0.00315
Reserves	0.0349	-0.131**	0.119	0.115	0.302	-0.00785**	-0.00177**	-0.00210**
Debt	1.791	3.004*	1.731**	1.554***	5.733***	0.0115	-0.00895*	-0.00746*
CA balance	0.383	1.902	-0.913	-0.693	-0.835	-0.0234	0.0211*	0.0183*
Observations	264	178	501	765	59	264	502	766
Adj. R-sq	0.942	0.960	0.905	0.913	0.960	0.601	0.587	0.586

\* FCL+ refers to countries identified as likely qualifying for the FCL by private sector analysts. \*\*\* 1%;\*\*5%;\*10% significance

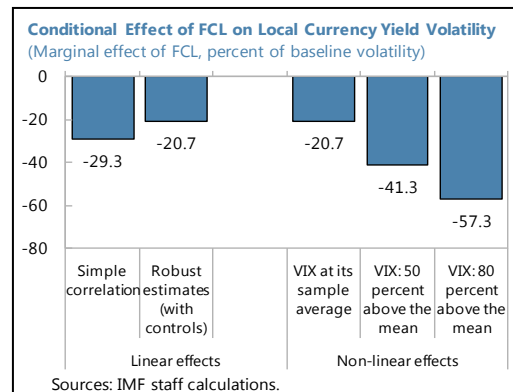
In addition to its impact on the level of yields econometric evidence also points to a strong and statistically significant impact of the FCL on yield stability. The conditional impact of an FCL arrangement on yield volatility seems significant and negative, even when a number of potential correlates of yield volatility (including country and alternatively year specific effects) are controlled for. The conditional impact is economically large—the reduction in yield volatility associated with the presence of the FCL (-0.6) is 20 percent lower than baseline yield volatility.

### Box 2. Impact of the FCL and PLL on Sovereign Spreads and Bond Flows (Concl.)

**The FCL instrument also seems to have protected the three FCL users against the surge in yields following the Fed tapering announcement on May 22.** A panel regression of changes in EMBI bond spreads in 21 larger EMs on VIX and lagged changes in spreads shows that the event of May 22 significantly increased yields: In the four weeks after the May 22 announcement, yields in EMs rose on average by an additional 14 basis points each week. Yet in the three FCL countries, that increase was lower by over 4 basis points, suggesting markets required lower additional risk premia from FCL countries relative to their peers.

**FCL countries faced lower risk premia increases after May 22 relative to peers**

	Change in EMBI spreads
VIX	0.568***
Lag 1	0.0619**
Dummy for May 22 - June 14	14.32***
FCL dummy for May 22 - June 14	-4.583***
Observations	1071
Adj. R-sq	0.042



1/ This box was prepared by Franto Ricka (SPR) and Christian Ebeke (EUR).

2/ Estimated using fixed effects with robust standard errors, and their results are robust to including other control variables, including fiscal balances, changes in cross-country bank claims as well as trading partner growth or oil price changes. The same specifications were run for a larger set of EMs without a substantial qualitative impact on the FCL dummy coefficients or their significance.

3/ The coefficient on the FCL dummy when the regression is run for only Colombia and Mexico (not reported) is larger and statistically significant.

### Box 3. Lessons from Country Inquires into FCL and PCL/PLL Arrangement<sup>1</sup>

**Since the creation of the FCL and PLL, potential interest has extended beyond the set of former and current users, but formal expression of interest did not materialize.** While none of these countries expressed interest formally, the possibility of an arrangement was raised, resulting in internal considerations at a staff level. These cases can be divided into two categories: the first category consists of cases where the members' fundamentals and policy frameworks clearly fell short of qualification; the second category, including most of the cases under study, were closer to qualification, resulting in internal discussions amongst staff as to whether these members would qualify if a formal request were to be made.

**Why did countries that clearly fell short of qualifying express interest?** These members were attracted by the instrument design of no ex post conditionality under the FCL or focused ex post conditionality under the PLL. They were generally not aware of the different modalities of conditionality for these arrangements, with lighter ex post conditionality compensated by a strengthening of the qualification criteria (i.e., the ex ante conditionality). The difference between the SBA, PLL, and FCL, therefore, lies in the composition of ex ante conditionality (qualification) and ex post conditionality, with the SBA relying entirely on the latter, the FCL entirely on the former, and the PLL in between. Therefore, these cases point to the need to better communicate the nature of conditionality under the FCL and PLL.

**The cases that were closer to a possible qualification, hence triggering internal staff discussion, highlight the ambiguity surrounding what constitutes underperformance that can be considered consistent with the qualification requirements.** This applies especially (but not exclusively) to the PLL. The discussions tended to focus on the following areas:

- *Sufficient track record.* This is an issue for both the FCL and PLL qualification assessment and is particularly difficult for members that have recently emerged from a crisis. Some questions were: If a member had lapses in track record that allowed vulnerabilities to build, but managed to address them during the crisis, can this be considered a sufficient track record? Conversely, if a member had a good policy track record but failed to adjust appropriately during a recent crisis, then is a renewed announcement to undertake strong adjustment policies sufficient for qualification?
- *Upfront measures.* In some borderline cases, the members' performance may have been sufficiently strong or sound under favorable external and domestic conditions but deteriorated significantly after a negative shock. In some cases, staff considered the possibility of allowing the member to address apparent vulnerabilities by implementing upfront measures. It was concluded, however, that qualification must be based on current fundamentals, policies and commitments, rather than "conditional" on certain actions.
- *Institutional factors.* A very strong or sound institutional framework is one of the qualification criteria of the FCL or PLL, but it is not clear what institutional factors should be assessed. While monetary and fiscal institutions are clearly part of the assessment, the extent to which other environmental factors, such as the business environment, unemployment, or the crime rate, should be taken into account is less clear. In principle, a wide range of institutional factors could be important and seen as related to the ability to undertake adjustment. The FCL and PLL qualification assessments should focus on those factors which can either reflect or affect a member's ability to adjust when facing a shock.
- *Defining the threshold for substantial underperformance* under PLL qualification. There is no clearly-defined "threshold" for substantial underperformance—that is, the point beyond which a member's vulnerability would constitute substantial underperformance in one of the five qualification areas.<sup>2</sup> While establishing such thresholds would be difficult given the role of judgment in qualification, the lack of thresholds led to disagreements in borderline cases. It is particularly difficult to appropriately account for mitigating factors when headline numbers indicate substantial underperformance. For example: a member may have very high external debt but also sizeable liquid external assets; a member may have a very large current account deficit, but one that is mainly financed by FDI; a member may have a high level of public debt but the composition is favorable with long average maturity, low interest cost and little foreign currency denominated debt. This suggests the need for clearer guidance in qualification.

1/ This box was prepared by Ran Bi (SPR).

2/ Substantial underperformance in any area would disqualify a country from a PLL arrangement.

#### Box 4. Large Fiscal Adjustments and Institutional Quality<sup>1</sup>

**Existing work examining the conduct of fiscal policy and underlying institutions tend to find an important relationship.** Studies based on both cross-country analysis and case-studies find that institutional and political factors play an important role in achieving fiscal adjustment as well as in supporting counter-cyclical fiscal policy.<sup>2</sup> To further understand the prevailing institutional conditions in countries which implemented large fiscal adjustments, this analysis builds on risk indicators developed by other institutions which capture aspects of government stability, socioeconomic conditions, conflict, corruption, and bureaucratic accountability. The episodes of large fiscal adjustment, defined as an adjustment in the structural primary balance of at least 5 percent of GDP, are based on a 2010 study which identifies 33 episodes in emerging markets since 1984.<sup>3</sup>

**Although there is no clearly defined measure of institutional strength, other institutions have developed indicators which capture relevant aspects.** This work uses scores of institutional and political risk drawn from the PRS group (ICRG data), and the World Bank's database of political indicators. The benefit of using ICRG risks scores is that they are based on a consistent methodology to combine political, social and economic information with expert judgment from their analysts. A higher score indicates lower risk. The World Bank indicators are objective measures of parliamentary fractionalization, executive control of the legislature, and the vote share of the opposition parties. This analysis helps to inform which types of institutional and political variables are stronger in countries that have been able to adjust in the past. Ultimately, country-specific judgment is required to assess institutional quality.

**The analysis shows that better risk scores and greater executive control of the legislature are associated with episodes of large fiscal adjustment.** As a first step, a logit regression was used to test each individual component of the risk scores and political indicators, controlling for GDP growth and public debt to GDP. The dependent variable took the value of 1 if there was a large fiscal adjustment, as defined above. In both fixed and random effects specifications, various indicators of government stability, accountability, conflict, and executive control were found to be individually statistically significant and with the expected sign. Overall, the results from a multivariate logit regression suggest that large fiscal adjustments are associated with governments that have lower risk of government instability, and corruption, as well as more executive control. In addition, a higher risk of socioeconomic instability tends to limit the ability to undertake adjustment. These results are robust to different lag structures and the possible endogeneity of the control variables.

1/ This box was prepared by Preya Sharma.

2/ For example see "Chipping Away at Public Debt" (Mauro, 2011). "On Graduation from Fiscal Procyclicality" (Frankel and Vegh, 2012).

3/ Source: Strategies for Fiscal Consolidation in the Post-Crisis World, FAD, IMF (2010)

### Box 5. A New Framework for Measuring External Risks<sup>1</sup>

*An external economic stress index could be used to measure the extent to which external economic conditions relevant to a country's set of BoP vulnerabilities deviates from the norm. Large negative deviations would suggest a period of external economic stress, signaling a higher benefit from the insurance provided under an FCL arrangement. Staff work has demonstrated one possible form of such an index here. Applied to the three FCL users, the index confirms that Colombia, Mexico and Poland have recently all seen lower external economic stress than at the time of their first requests in 2009, even though Poland remains exposed to substantial stress through its links to the Eurozone and its financial system.*

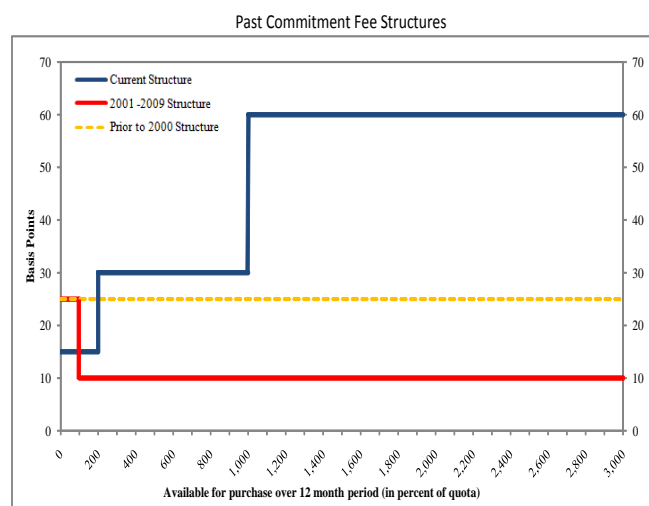
- **The external economic stress index focuses on areas of external vulnerability identified by country teams.** For each FCL user, the first step is to estimate (as a share of GDP) the size of each vulnerability listed in the most recent FCL staff report. In the case of Poland, for instance, such exposures include exports to the Eurozone, cross-border bank claims, FDI and portfolio capital inflows, and public external financing needs.
- **The index then incorporates a set of “stress variables” that are purely external to the country in question and considered most likely to trigger BoP pressures from each vulnerability.** Exports from Poland to the Eurozone, for instance, are likely to drop when Eurozone output falls, and equity portfolio flows to Poland will probably drop when investor risk aversion, as characterized by VIX and VXEEM, increases.
- **The index is an average of normalized deviations of the stress variables from their means, weighted by the relative importance of the vulnerabilities.** Each weight is determined by the vulnerability's size as a share of GDP relative to the total size of all identified vulnerabilities as a share of GDP. The variables' means and standard deviations are calculated using data starting in 1995 except for the mean price of oil, which is calculated using data since 2007 (due to a more structural rise in the oil price).
- **Applying the index to the three FCL users (Figure 1) shows that external stress has abated substantially for all of them since their first FCL arrangement requests.** Figure 1 confirms that most components of the index for the FCL users showed lower stress levels since their first requests. While all three experienced a temporary worsening in their external environment in the Summer of 2013, as portfolio funds moved out of emerging markets, only Poland remains under substantial external stress due to its exposure to a weak Eurozone and its banks.
- **The external stress index is well suited to evaluating forecasted levels of external stress using WEO baseline and downside forecasts.** FCL access discussions consider potential future external stress, and we calculate the index for both WEO baseline and downside forecasts. The latter suggest that, going forward, external stress for the FCL users could return to levels seen last summer even under the 2014 WEO downside scenario.
- **Ex-post evaluation of stress (which might have happened under past downside scenarios) is somewhat more complicated** as WEO downside scenarios have not always been consistent over time in their scope and focus. Nevertheless, Figure 1 includes a plot of past projected WEO downside risks as captured by the difference between the bottom 10<sup>th</sup> percentile and the baseline WEO global growth forecasts.

1/ This box was prepared by Franto Ricka (SPR).



### Box 6. Commitment Fees (1952-2009)<sup>1</sup>

**Commitment fees were originally put in place to help manage incentives and compensate the Fund for cases in which commitments were not drawn.** They were first introduced in conjunction with the establishment of the Stand-By Arrangement in 1952. Directors emphasized that while the charge should not discourage countries with need, it would serve as a deterrent to those who had no real reason to request Fund assistance. It was decided that a commitment charge of 25 basis points per year would be levied and if a member draws under the SBA, this charge would be credited against the service charge on a pro rata basis. In the context of the review of Fund facilities in 2000, a two-tier commitment fee schedule was adopted under which the fee remained at 25 basis points per annum for commitments up to 100 percent of quota and a lower 10 basis point fee was levied on amounts in excess of 100 percent of quota that could be purchased over the same period.<sup>2</sup> The



lower 10 basis point fee for access above 100 percent of quota was adopted mainly to encourage the use of the then-existing Contingent Credit Line (CCL) and the declining schedule was motivated by the lower probability of drawing under the CCL which made refunds less likely. The argument is consistent with the prevailing view at the time that the basic rationale for charging commitment fees for contingent credits was to cover the cost of establishing and monitoring Fund arrangements.

**The current commitment fee schedule stems from the 2009 GRA lending toolkit reform, and reflects an expanded role for liquidity risks management.**<sup>3</sup> Staff stressed the need to contain risks to the Fund liquidity associated with the FCL and expected greater use of HAPAs and proposed to revise the existing regressive schedule as it did not provide disincentives for excessive precautionary access. It was reiterated that large commitments have costs associated with the finite availability of Fund resources and such costs are likely to increase at the margin as resources available for other lending decline. In order to address these issues, the proposed new schedule increased progressively with access. Staff argued that such a commitment fee structure would generally increase incentives against unnecessarily high precautionary access and would also provide income to the Fund to help offset the cost of setting aside substantial financial resources. At the same time, commitment fees would not be set so high as to discourage members from seeking precautionary arrangements.

1/ This box was prepared by Rossen Rozenov and Lukas Kohler (FIN).

2/ See [Review of Fund Facilities – Proposed Decisions and Implementation Guidelines](#).

3/ See [GRA Lending Toolkit and Conditionality -- Reform Proposals](#).