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IMF POLICY PAPER

December 2017

ADEQUACY OF THE GLOBAL FINANCIAL SAFETY NET—CONSIDERATIONS FOR FUND TOOLKIT REFORM

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 9, 2016 consideration of the staff report.
- The **Staff Report**, prepared by IMF staff and completed on September 30, 2016 for the Executive Board's consideration on November 9, 2016.

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IMF Executive Board Discusses Proposals for Toolkit Reform, Concludes Review of the Flexible Credit Line and Precautionary and Liquidity Line

The Executive Board of the International Monetary Fund (IMF) has been discussing during the past year proposals to reform the Fund's lending toolkit, with the aim of further strengthening the Global Financial Safety Net (GFSN). In this context, the Board has considered a proposal for a new liquidity facility, as well as improvements to the Fund's existing instruments for crisis prevention as part of the Review of the Flexible Credit Line (FCL) and Precautionary and Liquidity Line (PLL). The reforms stemming from these discussions are part of the Fund's broader agenda to strengthen the GFSN, which also includes the recent introduction of a new Policy Coordination Instrument and an enhanced framework for cooperation with Regional Financing Arrangements.

The discussions were informed by three staff papers: "Adequacy of the Global Financial Safety Net—Considerations for Fund Toolkit Reform" (discussed by the Board on November 9, 2016), "Adequacy of the Global Financial Safety Net—Review of the Flexible Credit Line and Precautionary and Liquidity Line, and Proposals for Toolkit Reform" (discussed by the Board on June 30, 2017), and "Adequacy of the Global Financial Safety Net—Review of the Flexible Credit Line and Precautionary and Liquidity Line, and Proposals for Toolkit Reform—Revised Proposals" (discussed by the Board on December 6, 2017).

The Review of the FCL and PLL found that the instruments have been effective in providing precautionary support against external risks, and that successor FCL arrangements and associated access levels have been appropriately tailored to country circumstances. To enhance crisis prevention, staff developed a proposal for a new facility, called the Short-term Liquidity Swap (SLS), to provide members with very strong policies with predictable and renewable liquidity support against potential, short-term, moderate capital flow volatility. The SLS was designed as a revolving credit line, and included several other innovative features. However, the proposal was not adopted by the IMF's Executive Board. The Review also covered a possible role for a new Time-Based Commitment Fee (TBCF) in response to

concerns about prolonged use of high-access arrangements on a precautionary basis, but this proposal was also not adopted. Finally, the Review introduced refinements to the qualification framework for the FCL and the PLL to make it more transparent and predictable for actual and potential users.

Executive Board Assessment—November 9, 2016

Executive Directors welcomed the preliminary discussion of potential reform to the Fund's toolkit as part of the broader work stream on the adequacy of the global financial safety net (GFSN). They noted that the recent reforms to the GFSN have helped address the challenges of a more volatile and interconnected global economy. Since the global financial crisis, the GFSN has been strengthened considerably and become more multi-layered, with the overhaul of the Fund's lending toolkit, the set-up and augmentation of regional financing arrangements (RFAs), and the establishment of standing bilateral swap arrangements (BSAs) among reserve-currency issuing central banks.

These positive developments notwithstanding, most Directors shared the assessment that the current GFSN still provides uneven coverage. Many countries do not have reliable access to BSAs or RFAs, while very few take advantage of the new Fund instruments available on a precautionary basis. At the same time, while reserves provide an important line of defense, some countries may be relying unduly on them for self-insurance. Meanwhile, coordination among different layers of the GFSN leaves room for improvement. Noting the Fund's central role in ensuring a strong, effective GFSN, Directors broadly agreed that the Fund could help contribute to filling some of these gaps.

To this end, most Directors supported further work on revisiting and enhancing the Fund's toolkit for crisis prevention, with a view to improving its predictability and appeal to users, while continuing to promote sound policies. Many Directors noted that a comprehensive review of the existing toolkit would have provided useful insight, with some preferring further analysis of options for the Fund to support countries affected by commodity price shocks. Directors observed that stigma, which may in part explain the limited interest in the Fund's precautionary financing, is a complex issue that deserves deeper examination. While recognizing the need to address stigma concerns, Directors emphasized the importance of maintaining incentives for strong policies, minimizing moral hazard, safeguarding Fund resources, and avoiding overlap and a proliferation of instruments. They also underscored that strong frameworks and prudent macroeconomic policies are the first line of defense against crises.

Directors considered the merits of a new liquidity instrument to complement other layers of the GFSN and possible design features. Most Directors were open to considering further details, including annual re-qualification, revolving access, and a clause that would trigger a Board review if aggregate commitments under the instrument exceed a

predetermined threshold. In considering the access limit, a number of Directors urged careful consideration of the tradeoff between providing effective liquidity support for members and protecting the Fund's financial position and credibility. Many Directors remained to be convinced of the need for introducing a new instrument for liquidity purposes, noting, inter alia, scope for modifying existing precautionary instruments, the risk of overlap among Fund facilities, reputational risks, and the potential for repeated use with no exit expectations that could have a negative impact on the Fund's liquidity position. A few of these Directors also pointed to its feature akin to a swap line offered by central banks, which, in their view, risks departing from the Fund's traditional role under its mandate.

Directors expressed a range of views on the prequalification feature of a possible liquidity instrument. Many Directors saw the benefits of applying strong and transparent criteria to prequalify interested members with strong economic fundamentals and policy frameworks, which would eliminate the need for ex-post conditionality and, together with an opt-in option, help reduce stigma. Some Directors considered that qualification standards should be aligned with those for the Flexible Credit Line. Most Directors noted with some concern the signaling effects of prequalification and disqualification, which could lead to another form of stigma. While there may be merits in aligning the periodic prequalification process with members' Article IV consultation cycles, Directors emphasized the need to maintain separation between voluntary prequalification assessments and bilateral surveillance under Article IV. They urged staff to reflect more carefully on how to operationalize the idea of prequalification, if pursued, in order to preserve the quality and candor of Fund surveillance, maintain the Fund's role as a trusted advisor, and mitigate concerns about the signaling effects and a rating or tiering of the membership.

Directors highlighted the importance of maintaining coherence within the Fund's toolkit. They welcomed the staff's plan to develop specific modalities for a possible new liquidity instrument and clarify the role of each instrument in the reformed toolkit in the context of the forthcoming review of the Flexible Credit Line (FCL) and the Precautionary and Liquidity Line (PLL), taking into account Directors' views and concerns. Directors also called for a deeper assessment of potential demand and implications for the Fund's resources and liquidity position. Some Directors suggested that pricing options for insurance-type instruments also be explored to better rationalize scarce Fund resources. Directors took note of the staff's intention to also consider modifying the existing instruments available on a precautionary basis for the purpose of liquidity provision.

Directors broadly supported further work on a new policy monitoring instrument that could help countries better coordinate their access to the multiple layers of the GFSN and signal their commitment to a policy reform agenda. They generally concurred that the instrument could build on the existing Policy Support Instrument (PSI), with consideration of features such as: availability to the entire membership, upper credit tranche conditionality, a more flexible review schedule, and possibly a review-based monitoring of conditionality.

Some Directors felt that further work on this front would benefit from the discussion of the Fund's cooperation with RFAs. A few Directors expressed doubts about the potential demand for this instrument.

In light of today's discussion, and following additional consultations and outreach, including to RFAs as necessary, staff will return to the Board in the coming months with two separate papers. One paper would review the experience with the FCL and PLL, set out a more refined proposal for a new liquidity instrument, and discuss possible implications for the existing facilities and Fund resources. The second paper would propose a new policy monitoring instrument and provide further considerations for the future of the PSI.

Executive Board Assessment—June 30, 2017

Executive Directors welcomed the discussion of the review of the Flexible Credit Line (FCL) and Precautionary and Liquidity Line (PLL), and proposals for toolkit reform, as part of the Fund's broader work stream to strengthen the global financial safety net (GFSN). They recognized the complementarity of key reform proposals, and appreciated the staff's efforts and outreach to build consensus around a reform package. They welcomed the significant progress that has been made since the Board last discussed the issue in November 2016.

Directors generally endorsed the main conclusions of the FCL and PLL review. They broadly concurred that the FCL has provided effective precautionary support against external tail risks, and that successor arrangements and access levels have been consistent with the assessment of external risks and potential balance of payments needs. Nevertheless, most Directors remained concerned about the prolonged use of high-access precautionary arrangements and thus saw scope for strengthening price-based incentives. Many of them saw merit in introducing time-based commitment fees, some favored steepening the commitment fee structure to discourage unnecessarily high precautionary access, and a few saw scope for a combination of both options. Some other Directors reiterated that exit should continue to be state-dependent and did not see a case for stronger price-based incentives. Directors emphasized the need to ensure that staff reports for successor arrangements are explicit about the expectation of exit and exit strategies.

Directors broadly supported the proposal to use the core indicators and thresholds set out in Box 3 of the main paper to help guide judgment on FCL qualification by both staff and the Board. They agreed that this would help improve the transparency and predictability of the FCL qualification framework, ensuring that the FCL's high qualification standard is fully preserved, although a few Directors emphasized the need for flexibility in assessing qualification against certain benchmarks. Directors also welcomed the staff's plan to update the FCL guidance note to strengthen the implementation of the external stress index, with a few Directors suggesting a broader set of considerations to help inform discussions on access and exit. A number of Directors saw merit in considering additional reserve drawdown in

adverse scenarios as a way to support lower access levels, while a few others were concerned about its possible negative consequences.

Directors recognized that the proposal for a new liquidity instrument represents an important step toward strengthening the GFSN, complementing other layers. Most Directors supported the creation of a new Short-term Liquidity Swap (SLS) as a special facility to provide liquidity support for potential balance of payments needs of a short-term, frequent, and moderate nature, resulting from volatility in international capital markets. Most Directors considered that the proposed key design elements are broadly reasonable, with some calling for swift implementation of the new instrument. A number of Directors had reservations about some key features that, in their view, depart significantly from current Fund principles and policies, and hence warrant further reflection.

Directors welcomed the proposal to align the SLS qualification criteria and indicators with those of the FCL to ensure that it is used by members with very strong fundamentals and policies. While the alignment of qualification would facilitate transition from the FCL to the SLS (and vice versa) as external risks evolve, Directors stressed that it will be important that a request for any arrangement follow the respective processes for full qualification and approval. Directors noted that the proposal to make SLS qualification available year-round, like the FCL, helps address the concern that prequalification in the context of Article IV consultation could risk undermining the quality and candor of surveillance.

Regarding the proposed specific features of the SLS, most Directors could support revolving access capped at 145 percent of quota, with a 12-month repurchase obligation. A few Directors would prefer higher access for the facility to be more attractive and useful for member countries facing larger potential liquidity needs. Most Directors also considered the proposed service charge and non-refundable commitment fee as broadly reasonable, noting that given the special balance of payments need and revolving nature of the SLS, the overall pricing is comparable to that applied to other Fund facilities. Some other Directors were not convinced that the proposed differential fee structure is warranted or provides the right incentives.

Directors appreciated staff efforts and suggestions to minimize the perceived stigma of Fund support, which many Directors could support. Nevertheless, there remained concerns over the possibility of a central bank sole signatory, the absence of exit expectations, and the extension of an offer or the conditional approval of an SLS arrangement. Some Directors were also concerned about the negative signaling effect of de-qualification, particularly in the case of synchronized extension of offers, although others shared the staff's assessment that these risks should be manageable.

Directors reiterated the importance of maintaining a streamlined and coherent toolkit. To this end, they generally supported eliminating the PLL. While some Directors were concerned that elimination may be premature and would create a new gap in the Fund's

toolkit, most considered that the benefits outweigh the costs, given the low use of the PLL and broader concerns about tiering and proliferation of instruments.

Directors welcomed the analysis on the resource implications of the proposals. They noted the staff's expectation that the SLS could be accommodated comfortably within the Fund's existing quota-based resource envelope. Some Directors pointed to constraints facing the Fund's resource envelope and the potential that demand for the new instrument could be large. In this regard, some felt that staff estimates may be on the low side, considering also a possibility that potential SLS users could also request higher access under the FCL. A few Directors expressed concern that encumbering the Fund's balance sheet with insurance-type instruments, for a subset of the members that would qualify, could squeeze the resource envelope available for financing actual balance of payments needs.

Directors broadly supported the proposal to review the SLS after two years, or sooner if aggregate outstanding credit and commitments under the SLS and FCL exceed SDR150 billion. Given the innovative nature of the SLS and the potential effects on Fund resources, many Directors favored a clause establishing a timeframe for the Board to consider whether to renew or terminate the facility. A few other Directors did not see a need for such a clause, noting that it would undermine the usefulness of the new facility. On balance, most Directors were willing to go along with an emerging consensus. Directors generally supported full scoring of precautionary arrangements in calculating the Fund's forward commitment capacity (FCC) to provide clear assurance that committed resources will be available to the membership in all circumstances. Nevertheless, a few Directors saw some scope for flexibility in scoring these commitments against the FCC, given the low probability of drawing under such arrangements.

Directors encouraged staff to revisit outstanding issues and refine the proposals in light of today's discussion. They looked forward to a follow-up meeting to consider the package of reforms. They recognized that the reform proposals discussed today, if adopted, would require consequential changes to existing Fund policies.

Executive Board Assessment—December 6, 2017

Directors welcomed the opportunity to further discuss the review of the Flexible Credit Line (FCL) and Precautionary and Liquidity Line (PLL), and proposals for Fund toolkit reform, as part of the Fund's work to strengthen the global financial safety net (GFSN). They also highlighted other recent achievements in this work stream, particularly the establishment of the non-financing Policy Coordination Instrument (PCI) and the operational principles and framework for future Fund engagement with regional financing arrangements (RFAs).

Many Directors regretted that there was insufficient support to establish the Short-Term Liquidity Swap (SLS) at this juncture, particularly given heightened global uncertainty

and ongoing geopolitical risks. They noted that this type of liquidity facility could be an important addition to the Fund's lending toolkit and that several proposed features of the SLS could serve as a blueprint for further consideration of such a facility in the future. Some Directors recalled their reservations regarding the SLS proposal. Many Directors encouraged further consideration of the coherence of the lending toolkit and coverage of the GFSN going forward.

Directors agreed to complete the scheduled review of the FCL and PLL. A few Directors expressed preference to eliminate the PLL on the basis of its low usage, perceived tiering vis-à-vis the FCL, and overlap with precautionary Stand-By Arrangements (SBAs). Other Directors reiterated concerns that eliminating the PLL could open up a new gap in the toolkit. On balance, most Directors supported the retention of the PLL.

With the PLL remaining part of the toolkit, Directors supported the proposal to extend to the PLL the use of the same core indicators and thresholds already adopted as part of the FCL qualification framework, as set out in Box 1 of the Board paper. They noted that these indicators and thresholds will help guide assessments on PLL qualification by staff and the Board without changing the PLL qualification standards. Directors stressed that judgment should continue to be applied in FCL and PLL qualification assessments. Directors welcomed the plan to revise the FCL and PLL guidance notes to reflect the new indicators, as well as to improve the implementation of the external economic stress index and the assessment of the impact of reserve drawdown on access levels.

Directors discussed the merits of strengthening incentives for a timely exit from arrangements in the credit tranches that provide members with very high access to Fund resources over a prolonged period. They broadly concurred that the FCL has provided effective precautionary support against external tail risks, and that successor arrangements and access levels have been consistent with the assessment of external risks and potential balance of payments needs. Some Directors also noted the staff's finding that there was no evidence of unjustified prolonged use of the FCL. Directors agreed that exit from precautionary Fund support should be state-contingent. Nonetheless, most Directors considered that the proposal of introducing a time-based commitment fee (TBCF) could strengthen price-based incentives to exit from prolonged use of high-access arrangements on a precautionary basis. A number of Directors, however, were not in favor of introducing a TBCF on the basis that it would run counter to the principle that exit from precautionary Fund support should be state-dependent. A few also expressed concerns that a TBCF could make requesting Fund arrangements for precautionary purposes less attractive to potential users. On balance, the proposal to establish a TBCF was not adopted.

Directors agreed that staff reports for successor FCL and PLL arrangements should continue to provide details on an exit strategy, including a statement on the expectation that access will normally decline when the right conditions (as set forth in BUFF/10/125) are in

place, underpinned by a sound and transparent analysis of the risks facing the member country and the authorities' efforts to increase the country's resilience, in order to guide market expectations while ensuring that exit continues to be state-contingent.

In accordance with the Board decision on streamlining policy reviews, the experience with the use of the FCL and the PLL will be reviewed in five years or more, or on an as-needed basis, while many Directors expressed a preference for the timing of the next review to be less open-ended and take place within five years.

INTERNATIONAL MONETARY FUND

September 30, 2016

ADEQUACY OF THE GLOBAL FINANCIAL SAFETY NET—CONSIDERATIONS FOR FUND TOOLKIT REFORM

EXECUTIVE SUMMARY

Growing demand for liquidity in the face of increased vulnerabilities calls for enhancing the liquidity support provided through the global financial safety net (GFSN). The global economy is experiencing a period of protracted uncertainty, marked by frequent episodes of volatility. Demand for liquidity has intensified, in particular from emerging markets, which are experiencing a build-up of vulnerabilities and the depletion of their fiscal buffers. The enhanced GFSN meets only partially this higher demand for liquidity. The IMFC and G20 have called on the Fund to further strengthen the safety net.

The uneven use of the Fund's toolkit for crisis prevention suggests the need to reconsider its design. Despite a major overhaul of the Fund's lending instruments available for precautionary financing, only a modest number of countries have used them. In particular, the lack of access to a liquidity backstop for members with strong policies—similar to the standing bilateral swap arrangements (BSAs) among central banks—limits the availability of Fund support over the whole duration of the shock during protracted periods of global uncertainty. Moreover, the need to resort to Fund financing still carries a high political cost (stigma) for some members.

To enhance further the Fund's toolkit for crisis prevention, consideration could be given to revisiting the existing toolkit and introducing new instruments.
The toolkit could thus be enhanced by: establishing a new facility for precautionary financing that would provide a "standing" liquidity backstop to members with strong fundamentals and policies for use when hit by liquidity shocks; and adjusting the existing toolkit to maintain cohesion. Any change to the Fund toolkit would need to take into account the tradeoffs between reducing stigma and containing moral hazard, while simultaneously safeguarding Fund resources.

A Fund policy monitoring instrument could improve the cohesion of the global safety net. As the GFSN has expanded and become more multi-layered, there is a need to improve cooperation across the different layers to unlock financing and signal commitment to reforms. Creating a policy monitoring instrument that is available to all Fund members could help in this regard.

Next steps. In light of Directors' views on these points, staff could come back with subsequent papers that lay out specific and detailed proposals for reforming the lending toolkit. While these papers focus on the GRA lending toolkit, a separate forthcoming paper will assess some aspects of the concessional lending toolkit.

Approved By
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I. INTRODUCTION

1. **The global financial safety net has undergone important reforms since the global financial crisis, but significant gaps in the architecture remain.** The GFSN—comprising international reserves, central bank bilateral swap arrangements (BSAs), regional financing arrangements (RFAs), Fund and other IFI resources, and market-based instruments—aims to achieve three main objectives: (i) provide crisis prevention mechanisms for members; (ii) supply financing when crises hit; and (iii) incentivize sound macroeconomic policies. The crisis revealed critical gaps in the GFSN and, while subsequent reforms have contributed towards better meeting these objectives, there is agreement that more needs to be done.

2. **The IMFC and G20 have called on the Fund to explore ways to further strengthen the GFSN.** The recent Board papers in which staff discussed strengthening the international monetary system (IMS) and assessed the adequacy of the GFSN provided a diagnostic of the current strengths and weaknesses of the system and proposed areas for reform.[1] Additional work has been requested by the IMFC to revisit the Fund's lending toolkit to:

- strengthen the Fund's approach to helping members manage volatility and uncertainty—including through financial assistance on a precautionary basis; and,
- develop non-financial instruments, such as a policy monitoring instrument covering emerging market countries (EMs) and advanced economies (AEs).[2]

3. **As part of this work, this paper lays out why enhancing further the Fund toolkit is central to strengthening the GFSN and what form the enhancements could take.** The paper is organized as follows. It first sets out the growing demand for liquidity support (Section II) in an environment of elevated uncertainty and more frequent episodes of volatility and assesses the extent to which the GFSN currently meets this demand (Section III). Section IV reviews the effectiveness of the Fund—a central part of the GFSN—in responding to these needs. Section V lays out potential avenues for reform, including the possibility of introducing two new instruments: (i) an enhanced liquidity backstop and (ii) a policy monitoring instrument. The aim of these reforms would be to strengthen the availability and predictability of timely safety net resources for many countries, enhance the ability of the various elements of the GFSN to work together in an effective way, and lead to better policies at a global level. The final section suggests issues for discussion. Should the Executive Board see merit in these potential avenues for reform, a more defined and specific set of proposals could then be developed by staff.

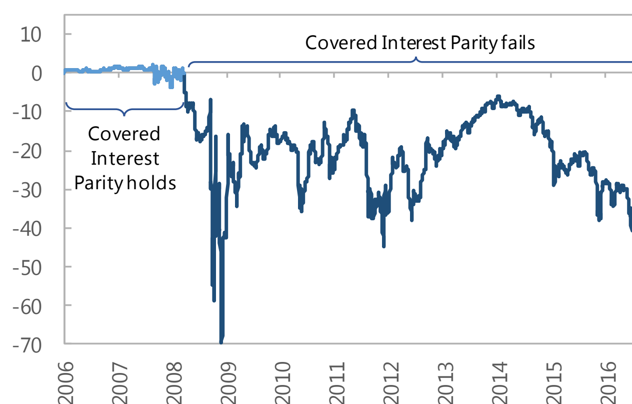
[1] See *Strengthening the International Monetary System*, IMF Policy Paper, February 2016 and *Adequacy of the Global Financial Safety Net*, IMF Policy Paper, March 2016.

[2] See IMFC Communique, Washington D.C., April 2016 and G20 Leaders Communique September 2016.

II. GROWING DEMAND FOR LIQUIDITY

4. In the wake of the global financial crisis (GFC), both policymakers and markets demonstrated increased demand for liquidity support. In 2013, six reserve currency-issuing central banks led the way by putting their existing network of bilateral swap lines onto a standing basis to "support financial stability by reducing uncertainties among market participants as to whether and when these arrangements would be renewed".[3] Non-reserve currency-issuing central banks have actively sought opportunities to establish (and renew/expand) BSAs with central banks that issue reserve currencies or have ample reserves. Some Fund members have privately expressed interest in access to similar, swap-like support from the Fund. Market participants have also signaled growing demand for dollar liquidity, despite the large supply stemming from U.S. monetary policy. This is manifested *inter alia* by the failure of covered interest parity across major foreign currency markets since the onset of the GFC, as measured by large FX swap spreads (Figure 1).[4]

Figure 1. One-year Cross-Currency Basis Swap vis-à-vis the US Dollar



Source: Bloomberg, IMF calculations.
Note: Simple average of the one-year cross-currency basis swaps for CAD, EUR, GBP, CHF and JPY vis-à-vis the US dollar. Negative values indicate opportunity for arbitrage by holding non-dollar assets.

5. The increased demand for liquidity provision is in part a function of the underlying structural changes that have transformed the global economy. EMs have become more integrated into the global economy and financial interconnectedness has become much more pronounced.[5] Global financial cycles have increased in amplitude and duration, capital flows have become more volatile and nonbank finance channels have expanded. While AEs continue to dominate the global banking system, and financial integration and deepening in EMs has progressed at a slower pace than trade integration, the size of EMs' cross-border liabilities has increased dramatically, intensifying the probability of a foreign-currency liquidity shock.[6] Moreover, with a large share of cross-border activity denominated or settled in U.S. dollars, exposure to risks associated with global dollar liquidity shortages has risen.

[3] See https://www.federalreserve.gov/monetarypolicy/bst_swapfaqs.htm.

[4] The change in financial regulations may have also contributed to the failure of covered interest parity. However, the timing of reforms does not appear to explain all deviations, especially in the immediate aftermath of the GFC.

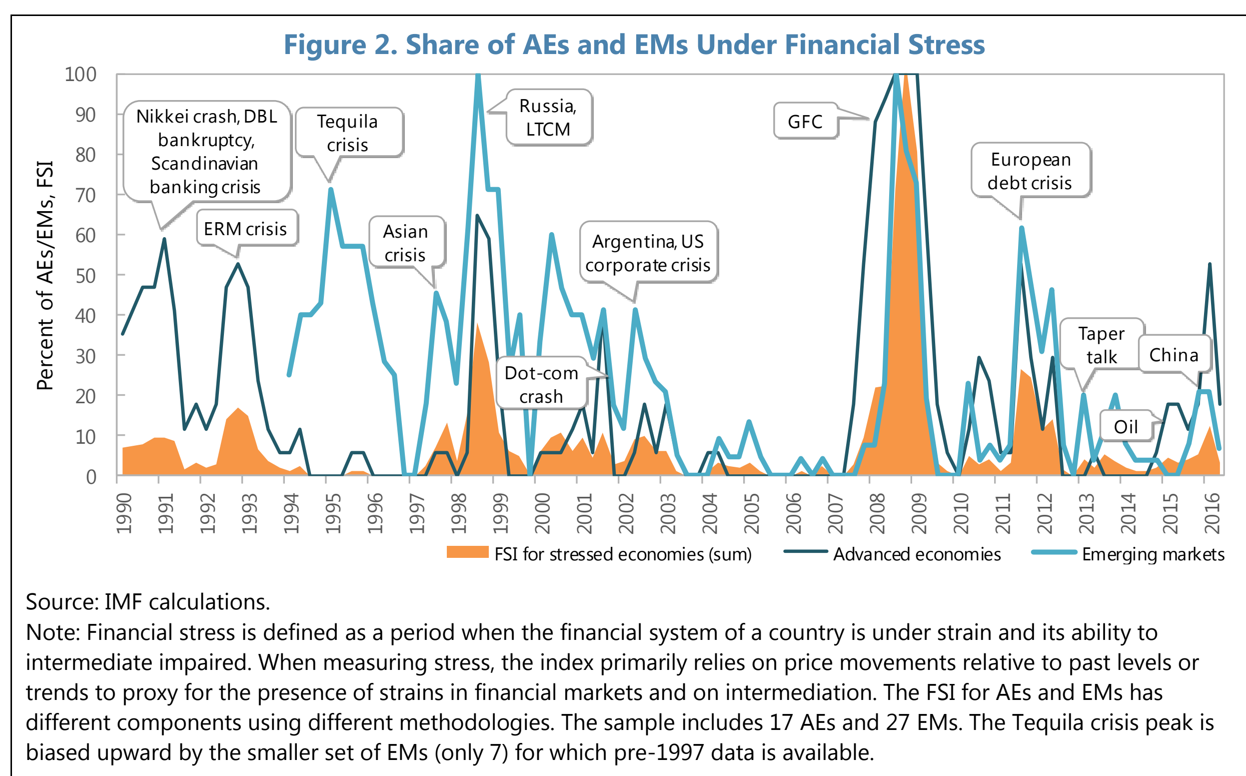
[5] See *Strengthening the International Monetary System—A Stocktaking*, IMF Policy Paper, March 2016.

[6] When there is a need for foreign currency liquidity, which a domestic central bank cannot print, government's ability to provide liquidity to markets (through foreign exchange intervention) or directly to market participants (as in an emergency loan to a bank) is constrained by its access to the GFSN.

6. Conjunctural factors have also played a role in creating a period of heightened and protracted global uncertainty. Global growth has remained weak and fragile since the GFC, held back by a combination of persistent interlinked forces—including unfavorable pre-crisis productivity trends, the legacy of high private and sovereign debt, and hysteresis. Moreover, the disappointing outlook remains flanked by significant risks, with major transitions set to continue for the foreseeable future: China's economic transition, persistently low commodity prices, and a divergence of monetary policy in the main reserve currency countries. In addition, fiscal buffers have declined in many countries in the wake of the GFC. As a result, policymakers will likely face an environment of tighter and more volatile global financial conditions for some time to come.

7. EMs are increasingly at the receiving end of "global" liquidity events. While pre-GFC EM crises were primarily triggered or enabled by domestic vulnerabilities, since then a growing number of liquidity shocks have been linked to developments in large AE and EM economies, including the European debt crisis, the "taper talk" episode and the China market correction (Figure 2). Consequently, the international community has renewed its focus on the need to provide liquidity support to members with sound policies.

Figure 2. Share of AEs and EMs Under Financial Stress



Source: IMF calculations.

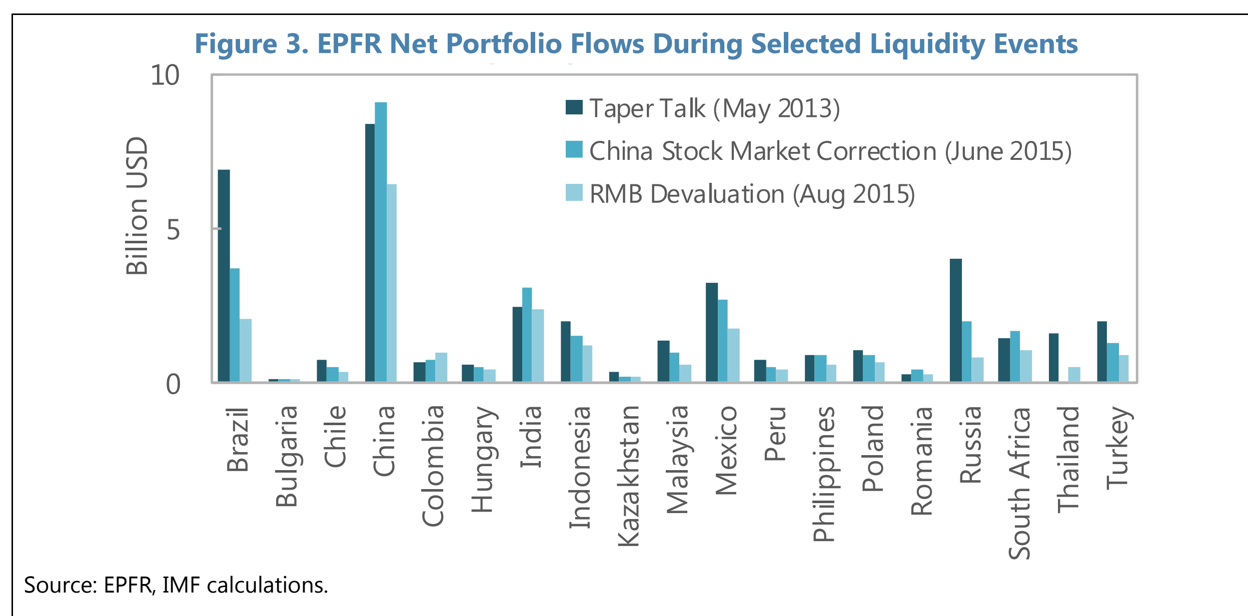
Note: Financial stress is defined as a period when the financial system of a country is under strain and its ability to intermediate impaired. When measuring stress, the index primarily relies on price movements relative to past levels or trends to proxy for the presence of strains in financial markets and on intermediation. The FSI for AEs and EMs has different components using different methodologies. The sample includes 17 AEs and 27 EMs. The Tequila crisis peak is biased upward by the smaller set of EMs (only 7) for which pre-1997 data is available.

8. Surprisingly, capital outflows from EMs in recent liquidity events have not been very large. While pervasive systemic tail risk crises are likely to trigger very large capital outflows,[7] this was not the case in more recent episodes. For example, Figure 3 shows that for a group of 19 large EMs, net portfolio outflows during the three months following the taper talk totaled around

[7] See *Adequacy of Fund resources—Preliminary Considerations*, March 2016.

US$30 billion, as reported by Emerging Portfolio Fund Research (EPFR), while those associated with the Chinese market correction and RMB devaluation in the second half of 2015 were around US$55 billion.[8] While EPFR has limited coverage[9], BOP data are broadly consistent with these findings (Figure 83).

Figure 3. EPFR Net Portfolio Flows During Selected Liquidity Events



Source: EPFR, IMF calculations.

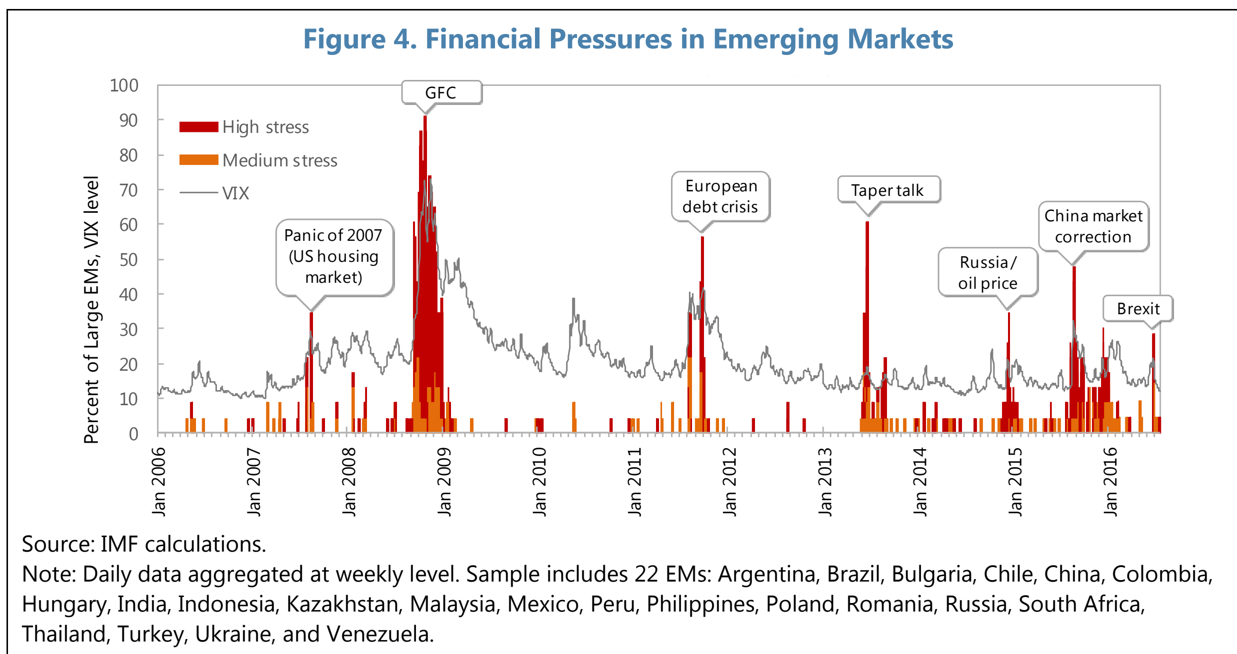
9. These small and generally short-lived but frequent liquidity events can have significant and persistent financial consequences for members. A new high-frequency indicator that measures financial pressures in EMs to help identify disorderly market conditions shows that around 80 percent of such conditions since the GFC occurred during global liquidity events, with up to two-thirds of EMs experiencing high stress during each episode (Figure 4).[10] The shocks are also highly synchronous, as evidenced by the fact that peaks rarely span more than a single week. At the same time, since the taper talk episode there has rarely been a week not marked by disorderly market conditions in at least one EM, indicating that overall financial conditions have deteriorated in recent years.

[8] Throughout the text and in figures, the sample of included countries does not provide any indication of potential qualifiers or users of a liquidity instrument. The broad focus is on advanced economies without a reserve currency, while the set of large emerging markets is limited by data availability.

[9] Generally, EPFR flows represent around one-fifth to one-quarter of BOP-reported portfolio flows.

[10] Disorderly Market Conditions are defined as stress situations in financial markets triggered by global and/or idiosyncratic shocks. The effects are usually amplified by excessively large or rapid FX movements and are compounded or mitigated by country-specific characteristics, such as macro imbalances, balance sheet FX exposures, financial market depth and structure, and policy framework.

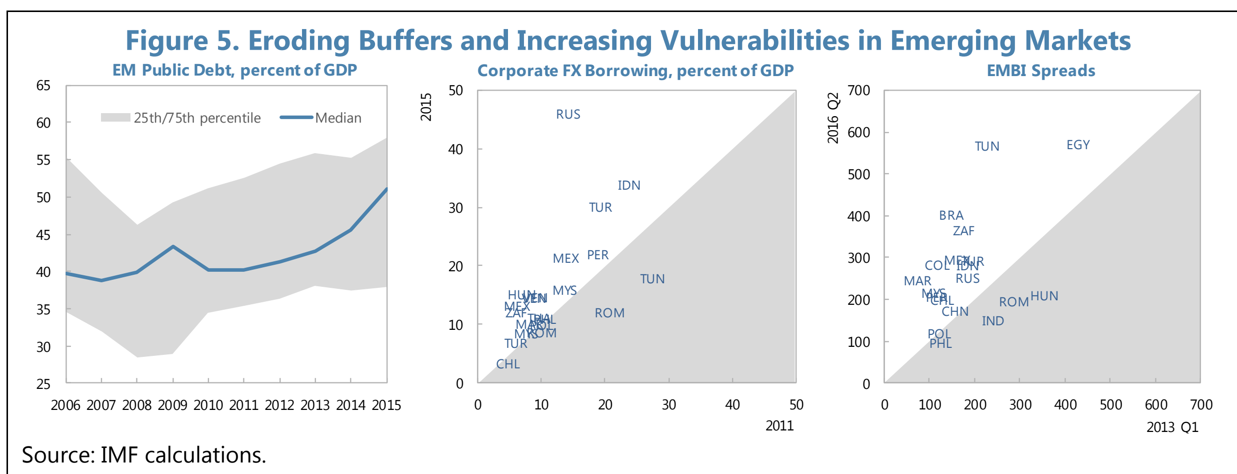
Figure 4. Financial Pressures in Emerging Markets



Source: IMF calculations.
Note: Daily data aggregated at weekly level. Sample includes 22 EMs: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Hungary, India, Indonesia, Kazakhstan, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, and Venezuela.

10. Although most EMs have managed to emerge from recent liquidity events relatively unscathed, they may prove more susceptible to future shocks. Stronger fundamentals and policy buffers generally served EMs well during the GFC and most countries have managed to successfully navigate the spate of global liquidity events that have followed in recent years. Nevertheless, the booms and busts in global liquidity and the repeated buffeting have taken a toll. Ample global liquidity created by highly accommodative monetary policy in AEs contributed to a further build-up in vulnerabilities—most notably an increase in EM corporate leverage with a concurrent build-up in currency mismatches[11]—and depletion of fiscal buffers may have left countries more susceptible to future capital flow reversals (Figure 5).[12]

Figure 5. Eroding Buffers and Increasing Vulnerabilities in Emerging Markets



Source: IMF calculations.

[11] For a discussion of currency mismatches in EM corporates see, for example, Chui, Kuruc and Turner, 2016, *A new dimension to currency mismatches in the emerging markets: non-financial companies*, BIS Working Paper 550.

[12] It should be noted that this reduction of public buffers by EMs with sound fundamentals (e.g., sharp increase of public debt-to-GDP at the 25th percentile) usefully contributed to boosting global demand in the wake of the GFC.

III. A LARGER GFSN, BUT WITH GAPS

11. Partly reflecting the increased demand for liquidity, the GFSN has expanded and become more multi-layered.[13] The network of BSAs among central banks expanded sharply during the crisis and continues to evolve. At the regional level, new RFAs have been established (e.g., the European Stability Mechanism (ESM) and the Eurasian Fund for Stabilization and Development (EFSD)), while existing RFAs have been augmented, including by increasing resources (e.g., the Arab Monetary Fund (AMF), the Chiang Mai Initiative Multilateralization (CMIM), and the Latin American Reserve Fund (FLAR)) and establishing new precautionary instruments (e.g., the BRICs Contingent Reserve Arrangement (CRA), CMIM, and ESM). At the global level, the Fund has enhanced its lending toolkit, including by establishing new and more flexible instruments that can also be used on a precautionary basis for crisis prevention—the Flexible Credit Line (FCL) and the Precautionary Liquidity Line (PLL). Self-insurance, though, continues to dwarf other elements of the GFSN, with the global stock of foreign exchange reserves growing throughout and after the crisis to around US$12 trillion by end-2015, well in excess of what would be warranted by the Fund's ARA metrics.

12. However, the GFSN coverage remains uneven. Outside the small standing network of BSAs between reserve currency-issuers, BSAs to other AEs and EMs for liquidity support have proven transitory; most were allowed to expire, and prospects of reestablishment are uncertain.[14] Many countries also either fall outside the scope of, or have limited coverage from, the new and strengthened RFAs. For members of some RFAs (BRICs CRA, CMIM, and ESM), precautionary support is often linked to a parallel Fund-supported program and remains largely untested. The use of the Fund's reformed lending toolkit has been uneven, with the new instruments available also for precautionary financing being used by a limited number of countries (see next section). As a result, some countries remain underserved by the system, with systemic and gatekeeper EMs, importantly, not having adequate access to predictable and reliable resources for the entire duration of the potential shock.[15]

13. Coordination across GFSN layers is underdeveloped. Countries may need to tap several layers of the GFSN simultaneously, but the coordination mechanisms remain underdeveloped. The more GFSN elements would be needed, the more challenging it will be to ensure timely provision of resources and coherent policy advice. Coordination is also largely untested; the Fund has limited experience working with some RFAs,[16] but cooperation with most RFAs remains untested.

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[13] For the definition, objectives, and a detailed discussion of the evolution and shortcomings of the current GFSN, see *Adequacy of the Global Financial Safety Net,* IMF Policy Paper, March 2016.

[14] Future reactivation of these BSAs would depend on the domestic policy considerations of the liquidity-providing central banks, as well as their non-transparent screening of potential users to mitigate credit risks.

[15] Gatekeeper countries are economies that belong to multiple trade and financial clusters and can act as transmitters of shocks between clusters. Systemic countries are economies with significant contributions to the global trade and financial networks. For a list of gatekeeper and systemic countries see *Adequacy of the Global Financial Safety Net,* IMF Policy Paper, March 2016.

[16] See *Crisis Program Review,* IMF Policy Paper, November 2015.

Box 1. A Diagnosis of the Current GFSN

The elements of the safety net can be assessed based on their predictability, speed, reliability, economic and political costs, and policy content. Will resources be available and accessible, and can their terms and conditions be anticipated (*predictability*)? How quickly can resources be activated and disbursed (*speed*)? Do resources provide coverage for the entire duration of the shock? That is, are they easy to renew or extend as needed throughout the shock period (*reliability*)? What are the financial and political costs (including stigma) of the resources (*costs*)? Do policies associated with the various elements provide the right incentives to prevent a build-up of external imbalances ex-ante and the appropriate correction of imbalances ex-post (*policies*)?

Characteristics	Reserves	Swaps	IMF	RFAs	Hedging
Predictability	2	1	2	1	2
Speed	2	2	1	0	2
Reliability	1	1	1	1	1
Cost	0 (Financial)	2	0 (Stigma)	1 (Stigma)	0 (Financial)
Policies	0	1	2	1	0

Red (0) = *Limited/insufficient* for predictability, speed, reliability, and policies, and *high* for cost; Yellow (1) = *Some*; Green (2) = *Extensive/adequate* for predictability, speed, reliability, and policies, and *low* for cost

Nearly all GFSN elements score poorly against the cost (financial and political) and policies criteria—highlighting important global inadequacies—and to a lesser extent reliability. Most elements have significant financial costs (e.g., reserves) or (stigma-related) political costs (e.g., the Fund, and to a lesser extent RFAs). Strong policy incentives for macroeconomic stability ex-ante and the appropriate correction of imbalances ex-post could mitigate moral hazard concerns, but only the Fund has an established macroeconomic policy framework. RFAs' policy requirements vary widely, and their application can be prone to political influence. Also, all elements of the GFSN suffer from insufficient reliability for more prolonged crises, as they provide only limited coverage over protracted periods of global uncertainty.

The current GFSN has serious shortcomings for most groups of borrowers, including systemic and gatekeeper EMs. When assessing the adequacy and effectiveness of the safety net, the borrower's perspective is important. For several relevant country groups, the "best available" combination of the GFSN elements (e.g., the combination of those elements that are available to that specific group and help them achieve their objectives) is assessed based on the same five criteria that were used for the assessment of the GFSN elements. While the safety net serves well the reserve currency-issuing AEs, it has shortcomings for all other groups of borrowers. Systemic and gatekeeper EMs have inadequate predictability and reliability (from BSAs) and high financial costs (from reserve accumulation) or political costs (from Fund stigma). From a global perspective, the GFSN fails to deliver on providing appropriate policy incentives, while insufficient predictability and reliability of resources lead to overaccumulation of reserves.

Characteristics	Reserve currency AEs	Other AEs	Systemic and gatekeeper EMs	Other EMs	DCs
Predictability	2	1	1	1	2
Speed	2	2	2	1	1
Reliability	2	1	1	0	1
Cost	2	1	0	0	0
Policies	0	1	1	1	1

Source: *Adequacy of the Global Financial Safety Net*, IMF Policy Paper, March 2016.

14. The current GFSN configuration is also inefficient—both for individual countries and globally—and does not adequately address moral hazard concerns (Box 1). Individual layers of the GFSN are subject to significant economic and political costs. Large reserve buffers entail high opportunity costs for individual countries, while excessive reserve accumulation has important global negative externalities, and could undermine the resilience of the international monetary system and reduce global demand.[17] At the same time, political costs associated with stigma remain very high for Fund support, and, to a lesser extent, RFA support. Furthermore, the GFSN fails to provide adequate incentives for countries to implement sound policies from a global perspective, with only the Fund having an established macroeconomic policy framework that is regularly and transparently reviewed and updated. This creates a risk of facility shopping and moral hazard.

15. Reforms can start at home. While fully addressing all these issues would require concerted efforts across all GFSN layers, the Fund can make an important contribution upfront by focusing on a few key gaps. The remainder of this paper focuses on these gaps and what might be done to address them.

IV. THE FUND LENDING TOOLKIT: REFORMS AND GAPS

16. The Fund's current GRA lending toolkit is designed to provide comprehensive coverage of member BOP financing needs.[18] Since the global financial crisis, the Fund has undertaken a series of reforms to streamline and address gaps in the lending toolkit. In doing so, the Fund has shifted its approach away from special facilities that address specific BOP problems, towards a more flexible framework that could address all types of BOP problems (see Box 2 for more details). As a result, the current toolkit includes various instruments that cover a wide range of access needs, including potential BOP needs, and are tailored to the strength of members' fundamentals and policies. There is also a range of financing options for actual BOP needs, based on the size, persistence and nature of the shock/required adjustment, as well as the strength of member policies (see Table 1).

17. The move towards a more flexible toolkit has both benefits and costs. This breadth of coverage underpins the high predictability of the Fund's crisis prevention and resolution support, with varying access limits and requirements, accessible to the near-universal membership. The shift away from special facilities towards instruments available for any type of BOP needs has provided more flexibility and more financing options for members. Nearly all Fund facilities and instruments in the GRA can theoretically be used to meet actual, prospective or potential BOP needs (see Figure 6). Nevertheless, this approach also has costs. The overlaps between instruments that can be used for any type of BOP needs reduce the clarity of the signals sent when a member seeks Fund support.

[17] See Obstfeld, M., 2011, *The International Monetary System: Living with Asymmetry*, NBER Working Paper No. 17641, December 2011.

[18] This policy paper focuses on the GRA toolkit. A separate forthcoming policy paper, "Financing for Development: Enhancing the Financial Safety Net for Developing Countries—Further Considerations" assesses and clarifies some aspects of the concessional lending toolkit, including the precautionary toolkit for LICs.

For example, as the key workhorse of the toolkit, the SBA is associated with use by members that have a need for actual financing and adjustment. As a result, this may have rendered it unattractive for some members that are looking for a purely precautionary arrangement.

Box 2. Recent IMF Toolkit Reforms

The Fund undertook a major overhaul of its non-concessional lending toolkit in 2009. In the wake of the global financial crisis, the Fund embarked on a process of reform to streamline and address gaps in the lending toolkit. A key objective was to ensure a more comprehensive and robust coverage of member needs within the GRA credit tranches, including a renewed focus on crisis prevention. In particular:

- The Contingent Financing Facility (CFF) and Supplemental Reserve Facility (SRF) were eliminated, in part due to the rigidity and artificial distinction of BOP needs addressed in these special facilities.
- The FCL was created to meet the demand for crisis-prevention and crisis-mitigation lending for countries with very strong policy frameworks and track records in economic performance.[1]
- The Stand-by Arrangement (SBA) and Extended Fund Facility (EFF) were retained. The SBA maintained its role as the "workhorse" of the toolkit, with reforms to allow high access arrangements in all BOP situations, including actual, prospective or potential BOP needs, in either the current or capital account. The EFF—designed to assist members with protracted BOP needs—was seen at that time as potentially more useful for LIC members.

Since then, further steps have been taken to refine the lending toolkit. Important refinements and additions were made in 2010 and 2011 to expand the coverage, enhance predictability and reduce stigma of Fund financing, particularly on a precautionary basis. Specifically:

- The duration of FCL arrangements was extended in 2010 to allow longer arrangements of two years—subject to an interim assessment of continued qualification—and the implicit cap of 1000 percent of quota removed to ensure better consistency with country needs.
- The Precautionary Credit Line (PCL) was introduced in 2010 for countries with sound policies that did not qualify for the FCL and had no actual (just potential) BOP needs. Like the FCL, approval was based on qualification criteria, but with streamlined ex-post conditionality focused on addressing remaining vulnerabilities. The PCL had an instrument-specific cumulative access limit of 1000 percent of quota and semiannual reviews to assess continued qualification and performance. In 2011, the PCL was replaced with the more flexible PLL that can be used for actual (as well as potential) BOP needs. A six-month "liquidity window" was also introduced for countries with actual or potential short-term BOP needs, that can make credible progress in addressing their vulnerabilities during the six-month period.
- In 2014, the qualification criteria for the FCL and PLL were clarified to enhance the transparency and predictability of qualification assessments and access decisions.[2]
- The Rapid Financing Instrument (RFI) was established in 2011 as a single instrument to consolidate and broaden the scope of the Fund's emergency assistance, including for urgent BOP needs arising from exogenous shocks (e.g., natural disasters), post-conflict and other fragile or disruptive situations. The RFI provides financing in the form of outright purchases, with low access limits, without a Fund-supported program and subject to only prior actions, where necessary.

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[1] The FCL aimed to address the gap in the toolkit left by the short-lived Short-term Liquidity Facility (SLF) that was introduced in October 2008 and had shorter repayment terms and a narrower BOP coverage.

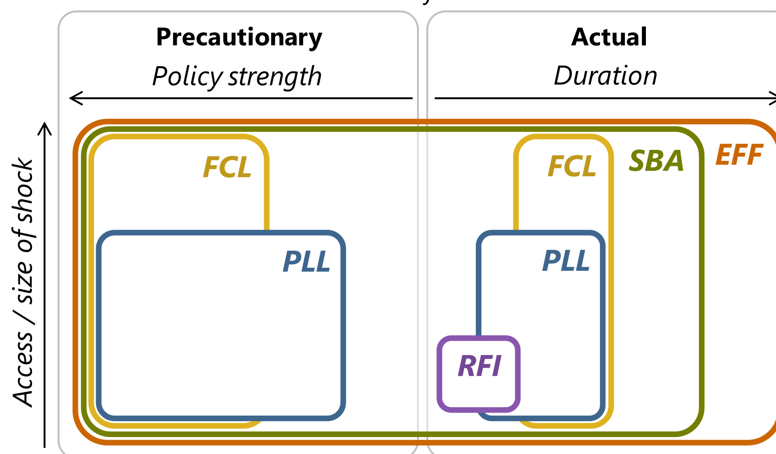
[2] See *Review of Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument,* IMF Policy Paper, January 2014.

Table 1. Current General Resource Account (GRA) Toolkit

FACILITY	BOP NEED	CONDITIONS	DURATION	ACCESS LIMITS (percent of quota)	CONDITIONALITY (EX ANTE/ EX POST) and Reviews
Credit Tranches					
Stand-By Arrangement (1952)	All actual, prospective or potential; short- to medium-term	Adopt policies to resolve BOP difficulties within a reasonable period	6–36 month arrangement	No cap. Exceptional Access criteria apply beyond normal access	Normally semi-annual reviews; PCs, SBs, and PAs
Flexible Credit Line (2009)	All actual, prospective or potential	Very strong ex ante macroeconomic fundamentals, economic policy framework, and policy track record	12/24 month arrangement	No preset limit	No ex post conditionality. Only ex-ante (qualification criteria); annual reviews for 2-year FCL arrangements
Rapid Financing Instrument (2011)	Actual, Urgent	Outline policy plans and commitments, and cooperate with the Fund to solve BOP difficulties (may include prior actions)	Outright purchases	Outright purchase 37.5% of quota; 75%of quota cumulative	No Fund-supported program; no ex post conditionality or reviews but PAs possible
Precautionary and Liquidity Line (2011)	All actual, prospective or potential	Sound policy frameworks, external position, and market access, including financial sector soundness	6 month arrangement (Liquidity Window)	125% per arrangements; 250% cumulative (latter due to exogenous shock heightened stress)	Semi-annual reviews; standard continuous PCs, PAs. Ex ante conditionality (qualification criteria)
			12–24 month arrangement	250% - first year upon approval; 500% - cumulative	Ex ante conditionality (qualification criteria) Semiannual reviews; ITs and continuous PCs; Other PCs, SBs and PAs as warranted.
Special Facilities					
Extended Fund Facility (1974)	Actual or potential (in exceptional circumstances); medium-term	Adopt program, with structural agenda and annual detailed statement of policies for the next 12 months	12–48 month arrangement	No cap. Exceptional Access Criteria apply beyond normal access	Normally semi-annual reviews; PCs, SBs, and PAs, focusing on structural reform

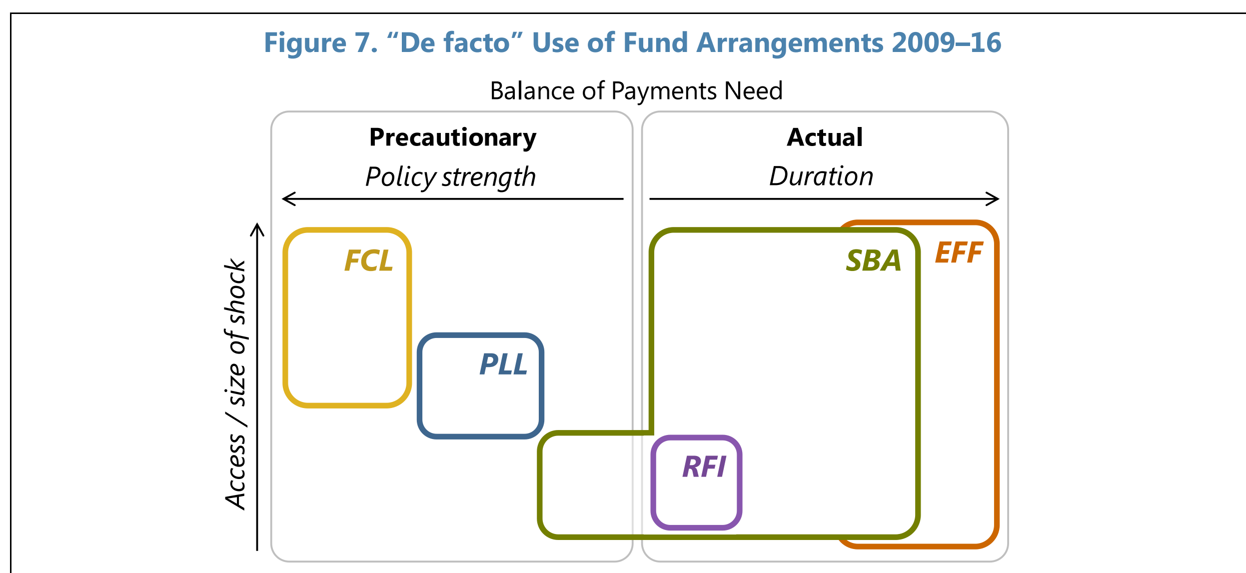
Figure 6. "De jure" GRA Toolkit

Balance of Payments Need



18. In practice, the Fund's toolkit has been largely used for financing purposes, with limited use of precautionary forms of support (see Figure 7). The membership has used the Fund's toolkit extensively for actual financing needs. There have been a large number of SBA and EFF arrangements since 2009, and while demand for the RFI was initially low, the instrument has been used four times since mid-2014. In contrast, use of the Fund's FCL and PLL has been more modest. While there have been 17 FCL arrangements, this has reflected repeated use by only three members, with the instrument used at high access levels as a backstop against tail risks. Use of the PLL (and its predecessor the PCL) has been even more limited, with only two countries accounting for a total of four arrangements—all at mid- to high-access levels. As yet, the 6-month liquidity window has not been used. In contrast, the SBA has been used on a precautionary basis by 10 members in a total of 14 arrangements, including joint SBA-SCFs, mostly at low- to mid-access levels.

Figure 7. "De facto" Use of Fund Arrangements 2009–16



19. Given the intensified demand for global liquidity, the relatively limited use of the toolkit on a precautionary basis suggests that it could be enhanced to better meet the needs of the membership. Few members have made precautionary use of the Fund's instruments during a period of intensified demand for liquidity support and at a time when costly self-insurance through excess reserve accumulation has continued apace. For many, the existing toolkit for crisis prevention is not considered to be well-suited to meet the current liquidity demands. As set out in the *Adequacy of the GFSN* Board paper, the Fund toolkit continues to score relatively poorly in a number of important areas:

- ***Reliability***—For Fund resources to be reliable sources of financing in periods of stress, members need to have access to these resources, once qualified, for the whole duration of the shock. Fund arrangements are reliable; once approved, and with an on-track program, arrangements can only be terminated by the authorities. However, they are subject to periodic reviews, and exit expectations in the FCL and PLL may put pressure on users. In the event of a prolonged period of elevated global risks, Fund support must be extended through successor arrangements—as seen in the repeated use of the FCL by a small number of members. The

Fund does not currently have an instrument that can provide the type of "standing" support, with features akin to those of bilateral swap agreements, that some members have expressed a strong desire for. Importantly, crisis prevention arrangements, as currently designed, do not provide sufficient flexibility: once an arrangement is drawn upon completely, the resources available to the member are depleted and are not automatically replenished, not even in the event of early repurchases.[19] In contrast, reserves and BSAs can be used (and re-used) with high frequency, to manage liquidity pressures during extended periods of volatility.

- ***Cost***—Fund resources are available at a very low financial cost. Nevertheless, they often involve significant political costs ("stigma"), which delay or prevent members from requesting Fund support. Efforts to address stigma through the special design features of the FCL and PLL (especially the use of ex ante conditionality (i.e., qualification criteria) as a full or partial substitute for traditional ex post conditionality), only benefit a small portion of the membership. Among the broader membership, there remains a widespread reluctance to use Fund resources, particularly on a precautionary basis. In addition, tiering within the Fund's crisis prevention toolkit may also generate stigma. Limiting some Fund facilities to a subset of countries singles out those who do not qualify. For example, the somewhat lower qualification bar has led to the perception that the PLL is a "second-class FCL",[20] while the high-access precautionary SBA (HAPA) is viewed as inferior to both. This may help explain the modest number of these arrangements since the creation of the FCL and PLL—a potential risk raised at the time of the toolkit reforms. Box 3 discusses stigma issues in more detail, setting out the various sources and ways that they could be addressed, including through the design and fine-tuning of new and existing instruments, respectively.

- ***Predictability***—while highlighted as a key Fund strength in the *Adequacy of the GFSN Board paper*, the transparency and predictability of the FCL and PLL instruments has been limited by a perception that the qualification decision is subject to considerable judgement. Although the qualification criteria for the FCL and PLL were sharpened in 2014, it is too early to say whether the issue has been fully resolved.

20. In Spring 2016, the IMFC called for the Fund to explore ways to help members manage volatility and uncertainty, including through precautionary financial assistance.[21] At the same time, the international community has called for a stronger IMF role in global liquidity provision, including through rapid liquidity instruments to deal with capital flow volatility.

21. In responding to these calls, it would be useful to consider adding a policy monitoring instrument to the Fund's toolkit that can help to improve coordination across the GFSN layers. Proposals for such an instrument were last considered at the time of the 2009 reforms. At the time, it

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[19] Unless there is an augmentation of access during the life of the arrangement.

[20] The juxtaposition of "very strong" policies and fundamentals required for FCL qualification and "sound" in the case of PLL reinforces the perception of tiering of the two instruments. The PLL factsheet also positions the instrument for "member countries with sound economic fundamentals but with some limited remaining vulnerabilities which preclude them from using the FCL." For survey results on facility tiering, see the 2014 FCL/PLL/RFI Review.

[21] See IMFC Communique, April 2016 (https://www.imf.org/en/News/Articles/2015/09/28/04/51/cm041616a).

was anticipated that SBAs approved on a precautionary basis could play this role. To some extent this has happened—with low-access arrangements used for signaling as well as precautionary purposes. However, the expansion and evolution of the GFSN, particularly the RFAs, has created new opportunities and demands for a versatile instrument that can facilitate coordination and catalyze support across GFSN layers.

Box 3. Sources of Fund Stigma

"Stigma" is an all-encompassing term associated with a reluctance of some members to engage the Fund for policy advice and financing. It can take one or more of the following distinct forms:

- **Economic stigma.** A request for a Fund program—whether for crisis prevention or crisis mitigation—can be viewed by markets as a sign of weakness and prompt capital outflow.
- **Conditionality stigma**. Even when optimally designed, conditionality could create a sense of intrusiveness and lack of ownership associated with Fund-supported programs.
- **Political stigma**. While originally rooted in economic and conditionality stigma, the persistently negative image that the Fund has among opinion leaders, NGOs and the general public in many parts of the world becomes a distinct, and increasingly important, reason for some policymakers' reluctance to approach the Fund.

While any form of financial engagement with the Fund can be viewed as stigmatizing for some members ("Fund stigma"), certain design features of the lending toolkit have contributed to the stigmatization of particular instruments.

- **Facility tiering**. Using qualification criteria to limit the availability of certain Fund facilities to a subset of countries in effect casts aspersions on the outsiders. For example, due to the somewhat lower qualification bar, the PLL is viewed as a "second-class FCL", and the HAPA is viewed as inferior to both. The use of qualification criteria also has benefits, however, in addressing conditionality stigma—hence there is a trade-off in toolkit design. Repositioning some instruments in the toolkit according to their different *purposes* could improve this trade-off by de-emphasizing the tiering aspect.
- **Exit stigma**. Exit from an arrangement approved on a precautionary basis due to qualification criteria no longer being met poses risks of negative market reaction. These risks can discourage countries from requesting such an arrangement in the first place.

Addressing Fund stigma involves a trade-off between global coverage and country-level effectiveness. Excessive stigma hampers the Fund's ability to promote good policies on a wider scale, as it pushes authorities to exhaust other options before turning to the Fund, ultimately risking deeper and more protracted crises, with potential spillovers to other countries. However, conditionality—a main driver of stigma—is instrumental to promoting good policies and necessary adjustment once a member turns to the Fund. A certain level of stigma is thus unavoidable.

Despite this inherent tradeoff, there may be opportunities to improve the balance, i.e., reducing stigma through instrument design without reducing the effectiveness of Fund-supported programs. This could include: (i) offering financial instruments that are clearly for precautionary purposes only (users have no need for adjustment financing); (ii) wider use of prequalification for such instruments, based on sound policies, to solidify the perception that a Fund program for crisis prevention is a signal of strength and (together with other safeguards) avoid the need for ex post conditionality, and (iii) making policy-monitoring support (i.e. without financing) more widely available to the membership, based on periodic reviews rather than "hard" conditionality. These ideas are discussed in more detail in Section 6.

V. REFORM OPTIONS

22. A number of measures could be considered to further enhance the Fund's liquidity and policy monitoring support. As discussed above, the Fund's lending toolkit was revamped in recent years with new instruments that allow for quicker access to liquidity with streamlined ex-post conditionality. The Policy Support Instrument (PSI), introduced in 2005, is an instrument designed specifically for policy monitoring. However, the qualification criteria for these facilities restrict their benefits to limited segments of the membership, while their design could potentially be further calibrated to better suit members' needs. Possible reform options include revisiting the existing toolkit and introducing new instruments, each of which entails different costs and benefits. Specific reform ideas are discussed further below.

A. A New Liquidity Instrument

Past Fund Experience

23. The idea of the Fund helping members with strong policies to protect against liquidity shocks is not new. It dates back to at least 1972 when the Economic Counselor at the time, Jacques Polak, prepared a note on "possible Fund financing of short-term capital movements". Other proposals followed in the wake of the capital account crises in the 1990s (see Annex 1). However, initial proposals for such Fund facilities either failed to be adopted (e.g. the STFF in 1994) or did not garner much interest among members once established (the CCL and SLF).

24. The experience with the CCL and the SLF suggests that Fund support needs to be sufficiently predictable and reliable to be attractive. Facilities that are perceived to have excessive safeguards are unlikely to generate interest among the membership as they tend to be insufficiently predictable (e.g., need for an "activation review;" lack of clarity on how eligibility criteria would be applied) and reliable (e.g., a temporary backstop may not last the full duration of the shock). Importantly, excessive safeguards also worsen stigma. Finally, the experience with the CCL illustrates how new modalities for Fund support need to be timely: demand for a liquidity backstop against financial contagion was widespread during the Asian financial crisis but appetite waned as conditions normalized.

25. While the design of the FCL and PLL took these lessons into account, demand remains modest, as highlighted in the most recent FCL/PLL/RFI review.[22] In particular, remaining stigma associated with the need to approach the Fund—and perhaps not be granted access under the identified instrument—remains a concern. In the case of the PLL, these issues may have been further compounded by the use of ex-post conditionality and the related sense of tiering relative to the FCL. The 6-month PLL attenuated stigma associated with ex-post conditionality, but usability was affected by the limitations on the repeat use of the instrument.

[22] IMF (2014) "Review of the Flexible Credit Line, The Precautionary and Liquidity Line, and The Rapid Financing Instrument".

Reform Options

26. A number of alternatives could enhance Fund liquidity support in ways that improve reliability and minimize stigma. The ideas below are not all new and each have benefits and costs.

- *Revisiting the existing toolkit for crisis prevention.* Reforms to the toolkit would need to be weighed carefully to ensure that they do not weaken the Fund's ability to facilitate any needed adjustment in members' economies or weaken the Fund's safeguards for the temporary use of GRA resources, a key requirement under the Articles. Piecemeal changes to existing instruments may also fall short of addressing the perceived stigma concerns to the extent that these have already been "tagged" by their experience so far. Against this backdrop, consideration could be given to: (i) revisiting the qualification criteria and duration terms of existing instruments so that more members could avail themselves on a precautionary basis without concerns over whether their duration sufficiently covers the period of anticipated volatility. In addition, to reduce stigma associated with a member having to resort to Fund support through a "request" for an arrangement, the idea of allowing a member to opt in to an arrangement rather than requesting one could be explored; (ii) options to introduce revolving access features to the FCL and PLL could also be explored—allowing members to reconstitute access as repurchases are made after drawings. Revisiting existing instruments, as opposed to introducing new ones, has the benefit of avoiding a proliferation of instruments.

- *Use of SDRs for liquidity provision.* Pooling and on-lending SDRs could be considered, for example, by creating a separate funding department for liquidity support, carving out General Resources on the Fund's balance sheet for traditional lending for balance of payments needs. This would require a change to the Articles of Agreement. Whether the SDR could play a broader role in the IMS will be addressed in the forthcoming Board paper.

- *Designing a new instrument.* A new liquidity facility could encompass the above reform options, while potentially being more effective in dealing with stigma by wiping the slate clean and defining a fresh purpose for the instrument. Such a new instrument could be designed with the additional aim of better promoting and creating incentives for implementing and maintaining good policies, addressing the biggest gap in the GFSN identified in IMF (2016). To avoid a proliferation of instruments in the toolkit, consideration could be given to revisiting the need for existing ones in the context of the forthcoming review of the toolkit for crisis prevention.

Design Features of a New Instrument

27. A new liquidity instrument would need to improve reliability and reduce stigma. This could be achieved by introducing a number of innovative design features—moving closer to "standing" liquidity support, providing credit which is "revolving", and making support available on the basis of streamlined prequalification and no ex post conditionality for members with strong economic policies and fundamentals. A number of safeguards—outlined below—could also be introduced in the design of the instrument to minimize both moral hazard and risks to Fund resources (credit and liquidity risks). While the design of the new instrument would make it accessible

to a wider segment of the membership than the FCL, and more appealing than the PLL, the SBA would remain the Fund's workhorse instrument, both for members that do not meet the ex-ante qualification criteria for other instruments and for those facing actual balance of payments needs.

28. Establishing a renewable, reliable backstop, similar to the standing BSA network established amongst six of the major reserve currency-issuing central banks would enhance the Fund's toolkit. The backstop would be aimed at providing support for use in the event of liquidity shocks of the relatively moderate and frequent variety. There would be no exit expectations and less stigma than with other instruments for crisis prevention that are de facto being used as backstops for the occurrence of tail events. It would also reduce incentives for accumulating *excessive* precautionary reserves and hence improve global resource allocation.

29. The new instrument would need to be designed to meet the requirements in the Articles of Agreement. Article V section 3(a) stipulates that the Fund establish *adequate safeguards* for the *temporary* use of the general resources of the Fund to help members resolve their balance of payments problems. Consideration could be given to potential design features to underpin the temporary use of Fund resources that might include:

- **Early repurchase expectations** that would encourage members to use the instrument only for temporary (typically self-correcting) BOP needs. Setting a relatively short term for repayment, e.g., one year, would help to manage Fund liquidity risks and help preserve the revolving nature of Fund resources.

- **Annual re-qualification**—i.e., based on an assessment at the time of the Article IV consultations—that would mitigate moral hazard and incentivize members to follow sound policies. If a member did not implement appropriate policies, its qualification for the instrument would lapse at the next annual assessment.

- **Limited access,** such that the backstop only covers liquidity needs likely to arise under relatively small-scale, short-term volatility. This would limit the aggregate call on Fund resources (see below) as well as minimizing credit risk. For example, one option would be to cap access under the instrument at 145 percent of quota—the current normal annual access limit.

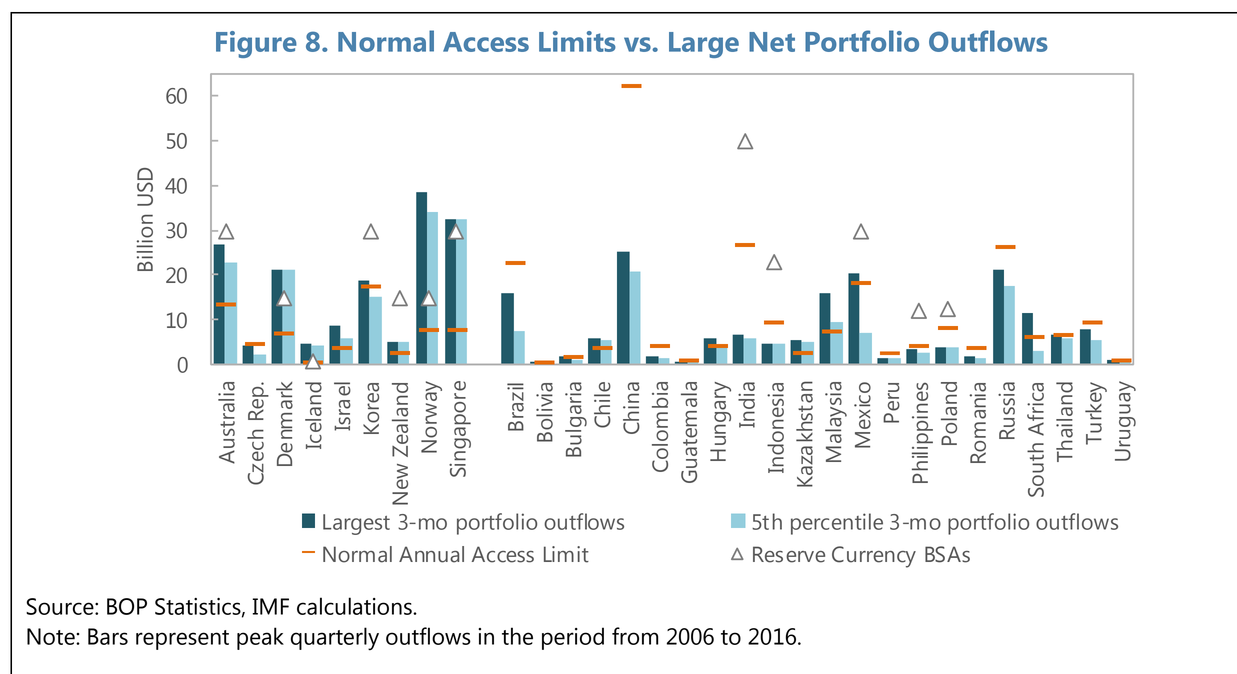
30. Consideration could also be given to the introduction of revolving credit—similar to central bank swap arrangements. Such a move would enable repeated purchases and repurchases under a single arrangement and across arrangements and move the Fund away from granting access under arrangements in terms of *flows* to one in terms of *stocks*. Within the prescribed access limit, a revolving-type feature would make the instrument more useful in addressing repeated short-term liquidity shocks, while limiting the impact on Fund resources and credit risk. The possibility of reconstituted access rights within the duration of an arrangement would improve reliability of access and make efficient use of Fund resources.

31. Prequalification and opt-in by qualifying members could also be considered. This might help improve predictability as to which countries would qualify and, importantly, eliminate the stigma associated with the need to approach the Fund and "request" a Fund arrangement.

Qualification criteria could be based on well-established analytical frameworks and perhaps be more parsimonious than for the FCL and PLL (see Box 4). Members could be prequalified periodically (e.g., in conjunction with the Article IV consultations), further limiting the stigma associated with requesting a Fund arrangement. Qualification criteria, however, would need to continue to be calibrated to ensure that qualifying members have strong economic policies and fundamentals, and an established track record of implementing appropriate policies. This would provide confidence that qualifying members would undertake adjustment if and when needed and seek to confine the use of the instrument to addressing possible short-term liquidity shocks.

32. If such a new liquidity instrument is established, further refinements to the existing financing toolkit may be desirable to maintain the overall coherence of the toolkit. Clarifying the role of each instrument in the reformed toolkit would be an important task to be undertaken as part of the upcoming review of the FCL and PLL. With a liquidity backstop aimed at providing support against small- to medium-sized liquidity shocks, staff would envisage the FCL as the exceptional-access counterpart, for use as a *temporary* backstop against extreme shocks/tail events, with an exit expectation. Since there would likely be a significant overlap between eligibility for the new liquidity backstop and the PLL—and given the lack of take-up and the issues of tiering vis-à-vis the FCL—the forthcoming review could consider whether or not to retain the PLL.

Figure 8. Normal Access Limits vs. Large Net Portfolio Outflows



Source: BOP Statistics, IMF calculations.
Note: Bars represent peak quarterly outflows in the period from 2006 to 2016.

Box 4. Qualification Criteria in the FCL and PLL and in the Prospective New Liquidity Instrument

The choice of qualification criteria for the new instrument would aim to ensure that qualification is predictable and transparent while ensuring strong fundamentals and policies and safeguarding Fund resources. While both FCL and PLL introduced ex-ante qualification as a meaningful step towards increasing predictability, they have only had limited use so far. The new instrument would retain pre-qualification as a key feature but envisage a more parsimonious set of criteria which, nevertheless, provide adequate assurances that members would take the appropriate policy measures when faced by a shock.

The FCL/PLL qualification framework aims to promote predictable and evenhanded qualification. Its core is an assessment that the member's policies, fundamentals and institutional policy frameworks are very strong ('generally sound' in the case of the PLL). The assessment is meant to give markets and the Fund confidence that the member would take appropriate policy actions when facing a shock.

Qualification for the FCL is based on nine qualification criteria, grouped into five areas in the case of the PLL. For the FCL, significant shortcomings on one of the criteria could preclude qualification while the PLL requires strong performance in most of the five areas; substantial underperformance in any area signals that the member does not qualify. A member would not be qualified if any of the following applies: (i) sustained inability to access international capital markets; (ii) need for large policy adjustments (unless credibly set in train); (iii) a public debt position that is not sustainable with high probability; (iv) widespread bank insolvencies. Under the qualification frameworks, an eligible member should also be assessed to have very strong or sound institutional policy frameworks for the FCL and the PLL, respectively.

Box Table 1. FCL and PLL Qualification Criteria/Areas

Area	Criteria
I. External position and market access	1. A sustainable external position
	2. A capital account position dominated by private flows
	3. A track record of steady sovereign access to capital markets at favorable terms
	4. A reserve position which remains relatively comfortable
II. Fiscal policy	5. Sound public finances and a sustainable public debt position
III. Monetary policy	6. Low and stable inflation, in the context of a sound monetary and exchange rate policy framework
IV. Financial sector soundness/supervision	7. A sound financial system and the absence of solvency problems that may threaten systemic stability
	8. Effective financial sector supervision
V. Data adequacy	9. Data transparency and integrity

The new instrument qualification framework would aim to continue ensuring strong fundamentals and policies, while relying on a more parsimonious set of criteria to enhance transparency and predictability. In particular, qualification for a new instrument could be based on three criteria: (i) a sustainable external position and market access, including adequate reserve coverage, sustainable external debt, and no significant exchange rate misalignment; (ii) sound public finances, as indicated by a sustainable public debt position with high probability; and (iii) no actual BOP need at approval. Moreover, an arrangement would not be approved for a member facing (i) bank solvency problems that pose an immediate threat of a systemic banking crisis; (ii) ineffective financial sector supervision; and (iii) insufficient data transparency and integrity.

Prequalification, the early repurchase expectations, and lower access than the FCL or PLL would all help safeguard Fund resources. Moreover, the annual reassessment of qualification, and the early repurchase expectations would help ensure that eligible members can be relied upon to undertake appropriate policy adjustments.

33. Financial resources necessary to establish a new liquidity backstop could be comfortably accommodated within the current envelope. As shown in Figure 8, net outflows for a group of 21 large EMs during recent episodes of short-term volatility were manageable relative to normal access limits for many countries, although such limits generally fell short of reserve-currency BSAs for those countries that could avail of them. For example, an EM-wide short-term volatility shock[23] would imply total liquidity requirements of around US$90 billion, which is equivalent to the largest existing FCL arrangement. And even in such a situation, the Fund would not be called upon for the full amount, as countries would be expected to partly cover the needs with reserves.[24] As an additional safeguard, the instrument could include a clause whereby the policy is subject to a Board review if the resource demands exceed a specified threshold.[25]

B. A New Policy Monitoring Instrument

34. With many countries needing to access several elements of the global safety net to fully cover their financing needs, better coordination is essential. While global resources have become increasingly decentralized—spread across and between different safety net layers—coordination has lagged behind. Fund experience working with some RFAs has identified areas for improvement, while cooperation with others still remains wholly untested.[26] With many countries needing to tap multiple sources of liquidity support to fill financing gaps in the event of shocks, there is renewed interest in strengthening coordination mechanisms that can help unlock access to different layers of the safety net. To assist members that do not wish to tap Fund resources but are seeking financing from other sources (RFAs, other international financial institutions (IFIs), or private investors), a credible policy monitoring instrument could facilitate a more efficient allocation of global resources and help reduce moral hazard by incentivizing stronger policies and reduce the problems associated with facility shopping.

35. There has long been demand from members for the Fund to provide policy monitoring, including for signaling purposes. The Fund provides policy guidance, monitoring and, often as a by-product, signals about a country's economic developments and policies through its operations. There are three main reasons why the Fund may be perceived as well-placed to play this role. First, the Fund may have better information than other official agencies and possibly some private agents through special access to policymakers, as well as institutional knowledge and experience. Second, country authorities may see the Fund as a desirable channel through which to demonstrate

[23] Calculated for each EM as the 5th percentile of net quarterly portfolio outflows from 2006 to 2016–see Figure 8.

[24] Of course resource needs for tail events, of the sort discussed in the Adequacy of Fund Resources paper, would be many times larger and call for alternative forms of financing under the exceptional access criteria.

[25] Nevertheless, the backstop would have an impact on the Fund's liquidity position. A liquidity backstop would imply a direct, semi-permanent call on Fund resources and there could also be important second-round effects on Fund liquidity, by removing members from the Fund's Financial Transactions Plan (FTP) in the event they draw under the facility to meet emerging actual BOP needs. Accordingly, the potential magnitude of second round effects would need to be kept under review and, if necessary, consideration could be given to increasing the size of the prudential balance. A backstop could also have implications for members of the FTP, as potential drawings would tie up part of reserves (at least for non-reserve currency issuers), resulting in lower returns.

[26] See Crisis Program Review, IMF Policy Paper, November 2015.

commitment to sound policies (its signals are viewed as credible). Finally, Fund engagement through a financing arrangement would provide comfort that the member has access to—or can quickly mobilize—additional resources.

36. As the GFSN has evolved into a more multi-layered system, the mechanism through which the Fund interacts with other elements and countries also needs to adapt. In light of the developments discussed above, there are two broad contexts in which countries would benefit from closer cooperation with the Fund, without the need for Fund financial resources:

- *Catalyzing financing from other GFSN layers.* Despite the increased capacity of RFAs to provide actual and precautionary financing for balance of payments needs, many continue to request some form of Fund involvement. The newer layers of the GFSN have yet to fully develop their expertise to assess economic performance, prospects, policies and institutions; some have outsourced—at least partially—this role to the Fund (e.g., CMIM and BRICS CRA). This more decentralized GFSN creates a need for more structured collaboration and coordination with RFAs and bilateral lenders and donors. Such a mechanism would also benefit countries seeking financial assistance from other IFIs and could replace the provision of assessment letters in cases where a more in-depth Board-endorsed assessment and monitoring may be needed.

- *Signaling commitment to a policy reform agenda.* A new government or a non-member government may often want to signal commitments to a new policy agenda and a "break from the past." In such instances, Fund engagement can help countries demonstrate commitment to sound policies and alleviate concerns about time inconsistency, in which a government attracts financing—private or official—by promising sound policies, only to renege on them once the financing is provided. A signaling mechanism that does not involve Fund resources but maintains upper credit tranche (UCT) level conditionality could fulfill the same role as a Fund arrangement.[27]

Past Fund Experience

37. In the past, the Fund has created a number of instruments for the primary purpose of signaling and policy monitoring. The historical experience provides valuable insights into the trade-offs involved in designing an effective signaling mechanism.[28] The key issues that have been raised are:

- ***The risk of becoming a "rating agency."*** There is a tension between informing creditors, often described as the Fund's catalyzing role, and a desire to leave markets to their own judgment when assessing risk and allocating resources. The Fund has avoided being perceived as a

[27] The standard of UCT aims at ensuring that: (i) policies will allow the member to solve its balance of payments difficulties in a manner consistent with the Articles of Agreement; (ii) the likelihood the Fund gets repaid is high, allowing it to meet its fiduciary responsibilities; and (iii) the Fund gets repaid reasonably quickly, consistent with the revolving nature of its resources. In the context of a monitoring and signaling instrument, this standard can be interpreted as signifying policies that are sufficient to correct any external imbalances within the program period.

[28] See *Signaling by the Fund—A Historical Review*, IMF 2004.

"gatekeeper" or "rating agency" at the risk of weakening market discipline and shifting focus towards certifying potential borrowers. As financial markets have matured and there is increased availability of economic information, however, there may be fewer grounds for concern that private creditors would rely excessively on the Fund's judgment.

- ***The difficulty in sending explicit negative signals.*** Negative signals can play a role in fostering sound policies and also provide credibility and power to positive signals. In practice, there has been a reluctance to send explicit negative signals at the risk of damaging the relationship with the authorities and impacting their access to financing. This issue is intensified when signals are blunt on/off mechanisms. While this challenge also exists for surveillance and Fund financing arrangements, it is mitigated (as noted above) by the growing abundance of economic information in most countries, such that the Fund alone is unlikely to bring a sudden and unexpected reassessment of prospects in a country. In addition, the signaling mechanism could be designed to provide a multi-dimensional assessment, eschewing a simplistic on-track/off-track accounting, provided that policy conditionality is equivalent to UCT standard.

- ***The credibility of signals without the backing of Fund financing.*** The lack of a commitment of the Fund's financial resources could weaken the signal as the Fund does not have a financial stake, unlike other official or private creditors. However, a contrary perspective is also possible: without pressure to provide financing, the Fund could be seen as a more impartial external assessor.

- ***Misinterpretation if standards are not upper credit tranche (UCT).*** The standard of UCT conditionality is so well-known that any other standard applied by the Fund in a signaling context could be misinterpreted as equivalent. This would risk undermining the quality of the signal and could adversely affect the perception of UCT-quality programs.

- ***Tension between on/off signals and more multidimensional assessments.*** When there are on/off signals, such as if a review is completed or delayed, there can be tendency to give less weight to the multidimensional signal. For example, creditors may place greater importance on the mere presence of an arrangement rather than the content of its assessments. To alleviate this risk, a new signaling mechanism would need to be accompanied by a clear communication strategy to emphasize the importance of the overall assessment provided in reviews.

Policy Monitoring Tools in the Current Fund Toolkit

38. Existing forms of policy monitoring are not appropriate or available in all cases. Within the current toolkit, there are some mechanisms that can play the role of providing policy monitoring and signaling. However, when assessed against the challenges of past experiences and the desire to ensure adequate coverage for all members, it is clear that important gaps remain.

39. Policy monitoring could be achieved through surveillance, but the standard against which policies are assessed would not provide a clear signal. Under the Fund's surveillance mandate, Article IV consultations provide policy advice and periodic assessments of the economic

outlook and policies of each member, typically once a year. However, it would not be clear what standard policies are assessed against. In addition, there are cases where more frequent monitoring is warranted but this is not possible under the current Article IV surveillance framework.[29]

40. Assessment letters and staff monitored programs (SMPs) play a signaling role but do not involve Board endorsement of policies and are designed for different objectives. Assessment letters are typically produced in response to requests from multilateral or bilateral donors or creditors when an up-to-date Board assessment is not readily available.[30] They should provide a clear and candid assessment of the member's macroeconomic conditions and prospects, and of macroeconomic and related structural policies. But they do not assess policies against any prescribed standard, and are generally not published. This limits their effectiveness as a mechanism for enhancing policy dialogue and monitoring. While staff-monitored programs do enable program-type engagement they are only used for the purpose of allowing countries to build a track record in anticipation of an eventual Fund-supported program, and not for signaling purposes. In addition, as with assessment letters, they do not entail an endorsement of policies by the Fund's Executive Board.

41. While arrangements used on a precautionary basis or the Policy Support Instrument (PSI) can be effective monitoring and signaling instruments, they are only available for a subset of the membership. A Fund arrangement used on a precautionary basis (e.g., SCF arrangement or SBA) can provide closer monitoring and a clear signal but would not be available for members that have no present, potential, or prospective need to draw on Fund resources, for instance because of substantial market access and/or access to other official sources of financing. Moreover, if the member's primary interest is to benefit from the structured policy engagement and signaling that the Fund can provide, it would be preferable to deliver this support via a monitoring program rather than tying up Fund resources in an arrangement used on a precautionary basis. The PSI provides such support but its availability is restricted to a subset of PRGT-eligible countries that have no present or prospective balance of payments need, do not require any significant macroeconomic policy adjustment and have sufficient quality of institutions and policies. The PSI helps such members design, implement and monitor policies as well as provide a Board-endorsed signal to donors and investors. There is, however, no comparable form of support available to the large majority of Fund members who are not eligible to use the PSI.

42. There is scope for improving the toolkit by building upon the experience with the PSI. This experience highlights the value that countries, creditors and donors place on the policy elements of a Fund-monitored program. Yet, there seems to be more limited value from the signal provided by the qualification feature of the PSI, and there is often a reluctance to disqualify countries even if performance deteriorates (see Box 5). In addition, there also seems to be a tendency to complete reviews even when there are indications that more time is needed to

[29] See Decision on Article IV Consultation Cycles (Decision No. 14747–(10/96)).

[30] Specifically, an assessment letter would be called for if either (i) the most recent assessment is more than six months old, or (ii) if Fund staff considers that there have been material changes in the country's circumstances that call for an updated assessment.

Box 5. Experience with the Policy Support Instrument (PSI)

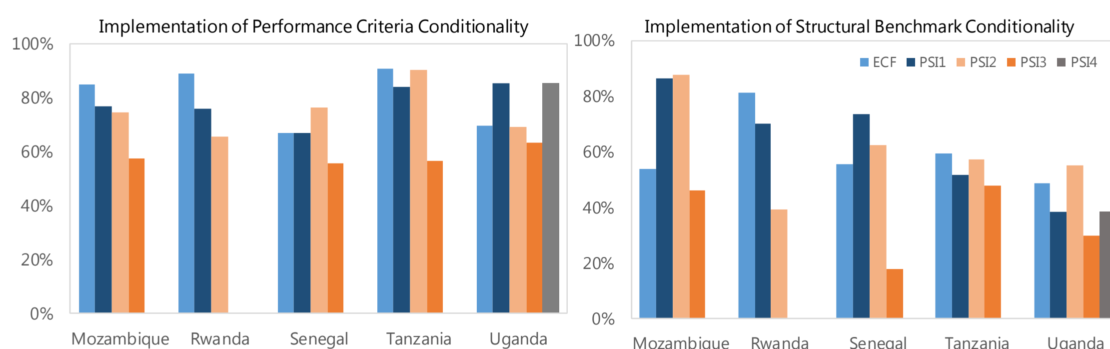
The PSI was introduced in 2005 to address a gap in the toolkit for PRGT-eligible countries that do not need Fund financial assistance. The PSI offers support to low-income countries (LICs) that have achieved macroeconomic stability and completed basic structural reforms, and do not need Fund financial assistance. For this group of countries, the PSI aims to promote a close policy dialogue with the Fund to help the member consolidate macroeconomic stability and pursue more advanced structural reforms, provide regular assessments of the member's economic and financial policies, and deliver clear signals that could be taken into account by donors, creditors, and the public.

Since its introduction, the PSI has been used by seven countries. A total of 18 PSIs have been approved to date in the following countries: Cape Verde (2), Mozambique (3), Nigeria (1), Rwanda (2), Senegal (3), Tanzania (3), and Uganda (4). Cases of concurrent use with Fund financial arrangements (to address short-term needs that arise during the implementation of a PSI) have been limited, with only three countries requesting an SCF (Tanzania 2012, Mozambique 2015, and Rwanda 2016).

Official creditors and donors value the signals provided by the PSI and use them in their aid allocation decisions. In a recent staff survey of donors in countries that are PSI users, all respondents agreed or strongly agreed that the PSI delivers clear and timely signals on the strength of country policies. Sixty percent of respondents also indicated that, to varying degrees, the PSI signals have played an important role in their aid allocation decisions, particularly in assessing countries' commitment to sound macroeconomic policies and management. Donors appreciate their collaboration with the Fund through the PSI, which provides a regular macroeconomic assessment and policy advice that complements the work of individual donors focusing on more sectoral issues. In past surveys, donors also indicated that the PSI was more useful than a surveillance-only relationship in making aid decisions.

PSI users have consolidated economic stability but evidence of sustained improvements in the implementation of structural reform is limited. Quantitative program targets, are generally met, but structural benchmark performance is inconsistent and weakening over subsequent PSI programs (Text Figure 1). The latter could be due to the difficulty of implementing second-generation reforms that follow-up PSIs aim to tackle. It could also be affected by the fixed review schedule under the PSI, which lacks the flexibility to meet targets with a delay.

Text Figure 1. Adherence to Conditionality in PSI Users (last ECF/PRGF and successive PSIs)

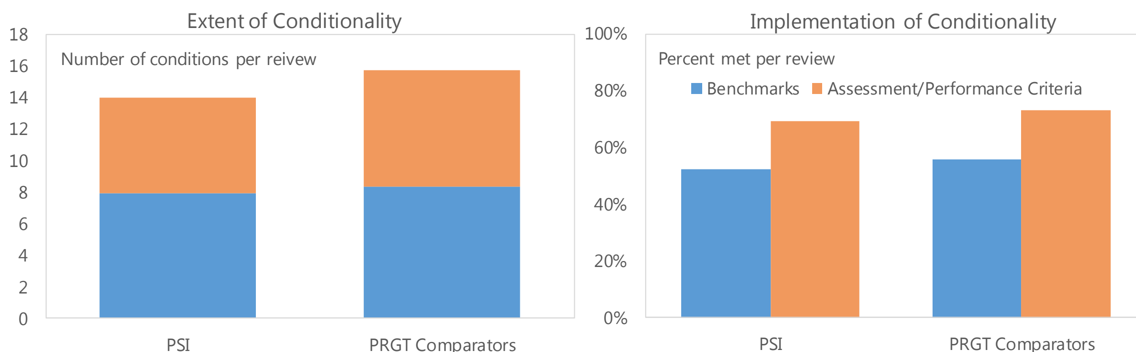


Overall, program performance with the PSI is not weakened by the absence of Fund financing. Comparing PSI users with similar PRGT-eligible countries that are using Fund financial facilities, the experience shows that:[1]

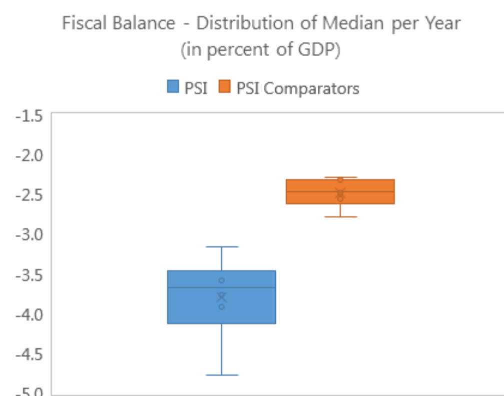
[1] As part of the 2008–09 lending reforms, structural performance criteria were discontinued and monitoring of structural reforms became review-based, though quantitative performance criteria were maintained. Evidence suggests that this did not lead to a weakening in the implementation of the structural reform agenda (see the 2015 Crisis Program Review, IMF 2015).

Box 5. Experience with the Policy Support Instrument (PSI) (concluded)

- PSI programs have less conditionality relative to comparator countries and other PRGT-eligible countries. This could be a reflection of PSI users having implemented first generation structural reforms and are now aiming for second-generation issues.



- PSI users typically have a higher fiscal deficit compared with comparable PRGT-eligible countries, in part explained by the scaling-up of investment. While the macroeconomic performance of PSI users and their comparators is generally similar (reflecting the selection criteria for the comparators), PSI users have higher fiscal deficits and public investment levels. A regression analysis indicates that the difference in fiscal deficit is driven essentially by higher investment by PSI users. Once investment is accounted for, being a PSI user per se is no longer associated with higher fiscal deficits.



The quality of signaling from the PSI may have been somewhat less sharp in recent years. Governance issues have affected some PSI users (corruption and large non-transparent off-budget spending) even though their macroeconomic performance has been broadly fine. Given that the assessment of performance under a PSI is mostly focused on macroeconomic issues, this allows completion of a review in circumstances where donors have withheld financial support due to governance issues. Also, the fixed review schedule under the PSI could put pressure for completion of reviews to the detriment of performance: in ten years, the only case where a review under the PSI was not completed is that of Uganda in 2011.

implement reforms—a phenomenon driven in part by the fixed review schedule. To help overcome these design issues in the PSI and create an instrument that could be used by a wider set of countries,[31] a new monitoring instrument could have the following characteristics:

- ***Avoid qualification criteria, to permit access for all countries.*** The main motivation for creating the PSI's distinct qualification criteria was to provide an on/off signal that identifies a subset of countries which have reached higher standards in terms of macroeconomic stability. Since the motivation for a new instrument is to enable a broader set of countries to benefit from

[31] As with the PSI, Fund engagement via the proposed new monitoring instrument would be a form of technical assistance (TA) (Article V, Section 2(b)). Fund TA to non-members is permitted with approval of the Executive Board.

Fund policy monitoring, establishing qualification criteria would unnecessarily restrict access for some countries, result in additional tiering in the membership, and possibly further contribute to stigma. The value of the instrument would derive from the policy dialogue and monitoring provided by the ongoing reviews rather than the binary signal of access to the instrument.

- ***Require UCT-quality policies, to provide a transparent and consistent standard.*** The UCT quality of policies is a clearly established standard that is applicable in programs with Fund financing. Maintaining this standard would be important in a new instrument that could be used to unlock financing from other GFSN components.

- ***Use review-based monitoring of conditionality to provide a clear signal on program performance and reduce stigma.*** Review-based monitoring of quantitative and structural reform conditionality would explicitly recognize that program reviews provide the context for a more robust and "real-time" assessment of program implementation.[32] Quantitative targets and structural reforms would remain central to program design but their monitoring would be modified to help reduce stigma. Specifically, countries would not need to be granted a formal waiver if a particular target is missed, as is currently the case with the PSI. Emphasis would be placed on the staff and Board assessment, which would provide a bottom-line appraisal as to whether policies are on track to meet the specified objectives, rather than focus on small deviations from specific targets.

- ***A more flexible review schedule to limit pressure to complete reviews but maintain regular updates on program performance.*** Committing to a fixed review schedule (e.g. every six months) ensures that information on program performance is provided regularly but can also result in pressure to complete reviews to avoid sending an overly negative signal. Creating a limited time buffer around reviews would enable some extra time if there are delays in implementation but avoid prolonged periods without an update on progress.

- ***Enable accelerated access to Fund-resources if needed.*** As is currently the case under the PSI, if the monitoring program is on-track this could expedite access to Fund financing in the event of a member's balance of payments need, subject to existing lending policies.

43. To maintain a streamlined toolkit, consideration could be given for the new instrument to replace the PSI. The proposed monitoring instrument would enable a broader set of countries to engage more closely with the Fund. If introduced, it could replace the PSI, perhaps after a trial period that would help the Board decide whether the new instrument has rendered the PSI obsolete.[33]

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[32] As part of the 2008–09 lending reforms, structural performance criteria were discontinued and monitoring of structural reforms became review-based, though quantitative performance criteria were maintained. Evidence suggests that this did not lead to a weakening in the implementation of the structural reform agenda (see the 2015 Crisis Program Review, IMF 2015).

[33] A comprehensive review of LIC facilities, including a review of the PSI, is planned for 2018. The experience with the new policy monitoring instrument (if adopted in due course) could inform that review.

VI. ISSUES FOR DISCUSSION

44. In this paper, staff has presented a number of avenues for further Fund toolkit reform to help address remaining gaps in the GFSN. In responding to the staff's analysis and suggestions, Directors may wish to address the questions below. In light of Directors' views, staff could come back with subsequent papers that lay out specific proposals in detail.

- Do Directors agree that there are remaining gaps in the Fund's toolkit?
- Do Directors agree that stigma remains an important concern that we should continue to address, including through new instrument design?
- Do Directors agree that remaining gaps are potentially best addressed through new instruments, rather than modification of existing instruments?
- Do Directors agree that there is a potential case for a new liquidity support instrument?
- Do Directors see merit in creating a new monitoring instrument?

Annex 1. Fund Facilities Serving Liquidity Needs for Members with Strong Policies

The Fund first considered facilities for helping members with strong policies deal with financial market volatility in the early 1990s, although the proposal for a Short-Term Financing Facility (STFF) was never adopted. Its successor, the Contingent Credit Line (CCL), was established in 1999 against the backdrop of financial contagion during the Asian crisis. The CCL was never used, however, in part due to stigma concerns and because it was perceived to be insufficiently automatic and predictable. The Short-term Liquidity Facility (SLF), established at the outset of the global crisis, was quickly replaced by the Flexible Credit Line (FCL) which aimed to address such concerns more forcefully. The Precautionary Credit Line (PCL) and its successor, the Precautionary and Liquidity Line (PLL), were introduced to spread some of the FCL's benefits to a wider range of members. However, both facilities have seen only limited use thus far.

Contingent Credit Line (CCL)

The CCL was established in May 1999, following the Asian financial crisis, to provide members with strong economic policies with a precautionary line of defense against contagion. The CCL was to provide higher and more frontloaded access (with shorter maturities) than conventional precautionary SBAs/ EFFs. Key design features included a formal request that encapsulated prescreening (ex-ante conditionality) as well as an activation review required to make an initial purchase of a substantial portion of access. Importantly, Board approval was conditional on determining that contagion was indeed the source of the member's problems.

The CCL expired in November 2003 without having ever been used. One reason for the lack of interest was stigma concerns related to the signal potentially conveyed by a CCL request; relatedly, members anticipated uncertainty in case a country with a CCL was no longer deemed eligible at a future point in time. Moreover, the instrument was seen as insufficiently automatic and predictable, both due to a lack of clarity of eligibility criteria and as a result of the complexity of procedures for activation. The need to establish that a member's balance of payments needs were indeed driven by contagion was seen to further complicate activation.

Short-term Liquidity Facility (SLF)

The SLF was established in October 2008 amid the liquidity squeeze in global financial markets. It aimed to help members with very strong policies and fundamentals deal with self-correcting and quick-reversing BOP needs, subject to pre-qualification and absent ex-post conditionality. As such, the facility addressed the concerns that weakened the CCL in part. Following an expression of interest, members facing temporary liquidity problems would be permitted purchases up to a cumulative limit of 500 percent of quota subject to a Board decision that eligibility criteria are met. Repurchases would have to be made three months from the relevant purchase.

While the SLF was terminated in 2009, and thus too early to establish conclusively lack of member interest, several design issues kept members away from the instrument. These

included (i) the outright purchase nature of financing, which prevented use on a precautionary basis; (ii) the capped access and short repurchase period; and (iii) high borrowing service charges when purchases are made.

Flexible Credit Line (FCL), Precautionary Credit Line (PCL) and Precautionary and Liquidity Line (PLL)

The FCL was established in March 2009 to provide large, upfront precautionary financing to members with very strong fundamentals and policies. In line with the SLF, the FCL aims to reduce stigma and increase predictability by entailing no ex-post conditionality. It further includes an ex-ante qualification framework and is established as a window in the credit tranches. As such, it can be used to address (potential or actual) financing needs stemming from any type of balance of payments problem. In the same spirit of increasing flexibility and predictability, there are no restrictions on requesting a successor arrangements and, in August 2010, the initial cap on access was lifted.

The Fund created the PCL in August 2010 to spread some of the benefits of the FCL to a larger subset of the membership. Both access and the qualification bar are correspondingly lower than in the FCL, although PCL eligible members were required to have sound fundamentals and policies. In light of potentially remaining vulnerabilities, the PCL combined ex ante conditionality (qualification criteria) with focused ex-post conditionality. The PCL was renamed PLL in November 2011 to reflect the decision to make it more flexible through broadening eligibility to members with actual balance of payments needs and creating a six-month liquidity window under the facility.

Usage of the FCL and PLL remains modest despite the recent period of elevated market volatility, reflecting a number of reasons. First, the high qualification bar may have limited the number of potential qualifiers, some of which see no need for additional insurance given existing external buffers. Second, qualification criteria may not have been clear enough, especially for the PLL, as the minimum standard for eligible members is difficult to identify. Third, stigma concerns related to the need to approach the Fund remain, in part, due to the lack of pre-qualification. Indeed, members may have been reluctant to request Fund financing individually for fear of negative public perception in the event that none of their peers would end up doing so (first mover problem). Finally, the introduction of multiple instruments has created a system of tiering that was partly intentional but may have made the PLL less attractive.

Six-Month PLL Liquidity Window

The creation of the PLL allowed for arrangements with shorter duration as a platform to address the needs of crisis bystanders during periods of heightened stress and contagion. The 6-month PLL can be approved based on an actual or potential balance of payments need, although such need would have to be of a short-term nature such that it can generally be expected to make credible progress in addressing its vulnerabilities during such six-month period. All other qualification criteria would be the same as in a PLL with longer duration. Repeat approval of 6-month PLL arrangements is limited to prevent usage to meet balance of payments needs that are

not of a short-term nature. Similar to an FCL, the 6-month PLL would, in turn, not be subject to a review or to other forms of ex-post conditionality beyond the standard performance criteria.

There has thus far been no sign of interest in the 6-month PLL. While the almost non-existent ex-post conditionality[1] may have attenuated stigma concerns compared to a PLL of longer duration, the 6-month PLL is likely subject to the same concerns regarding the high bar and limited predictability of qualification. Similarly, the tiering between FCL and PLL may have limited the use of PLL arrangements of both short and longer duration. Due to the requirement to identify balance of payments needs of a short-term nature, the qualification process for the 6-month PLL may be perceived to be especially complicated. Finally, limiting repeat use of the instrument may have further reduced its attractiveness.

[1] 6 month PLL arrangements still require standard continuous performance criteria. Prior actions are also possible when needed.