

INTERNATIONAL MONETARY FUND

**Strengthening the Fund’s Ability to Assist Low-Income Countries Meet  
Balance of Payments Needs Arising from Sudden and Exogenous Shocks**

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(In consultation with other departments)

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## I. INTRODUCTION

1. **At the Executive Board discussion on the role of the Fund in low-income countries, Directors requested specific proposals to address the absence of concessional instruments other than the PRGF in the Fund's financial assistance to low-income members facing exogenous shocks.**<sup>1</sup> Directors observed that, while PRGF augmentation remains an effective tool when a PRGF arrangement is in place, the needs of other low-income members without a PRGF arrangement and with low capacity to bear debt are unaddressed. Although access to the credit tranches under stand-by arrangements is available to all members, Directors considered that for low-income countries, such access was only suitable for members with the capacity to service debt on credit tranche terms. Most Directors also observed that subsidizing charges on credit tranche purchases, including under stand-by arrangements, would not be an effective approach; even with the subsidy, the level of concessionality of such an instrument would still be considerably lower than that under a PRGF arrangement and would therefore not significantly ease the debt burden for these countries. Many Directors concurred that a stand-by like window within the PRGF Trust would be more appropriate, although several Directors did not support this approach, expressing concerns that such a facility would erode PRGF program design.

2. **Against this background, this paper analyses the main issues in designing such a window within the PRGF Trust.** It concludes that modification of the PRGF Trust to create a second window could play a useful role in allowing the Fund to assist low-income members facing a need for adjustment and temporary Fund financing arising from a sudden and exogenous shock. The existing PRGF window would continue to be available to help qualifying PRGF-eligible members address protracted balance of payments problems. Besides giving the Fund the capacity to provide concessional support to those members that do not have PRGF arrangements, the second window would provide a potential safety net for those members that might wish to exit continuous PRGF-supported program engagement. To safeguard PRGF resources, the second window would apply the standard of upper credit tranche (UCT) conditionality, and the qualification criteria would ensure that use of Fund resources under the second window would not be used when a standard PRGF arrangement would be more appropriate.<sup>2</sup>

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<sup>1</sup> [\*The Fund's Support of Low-Income Member Countries—Considerations on Instruments and Financing\*](#), and [PIN No. 04/40 \(April 15, 2004\)](#).

<sup>2</sup> The use of PRGF resources for standard PRGF operations will be referred to in this paper as the “standard PRGF,” to distinguish it from the proposed window within the PRGF Trust, called the “PRGF second window” for brevity. It should be understood that the standard PRGF and the PRGF second window would be two distinct features within the PRGF Trust. Specifically, the second window would be designed to assist PRGF-eligible countries adjust to shocks, using PRGF Trust resources.

3. **There are alternatives to a PRGF second window for low-income members without a PRGF arrangement, but they fail to cover the full range of situations facing low-income members.** In cases where a country is clearly hit by an exogenous export shortfall (and there is otherwise no additional balance of payments need), members may avail themselves of assistance under the Compensatory Financing Facility (CFF). Stand-alone CFF access requires that the balance of payments situation be satisfactory apart from the export shortfall. Because of the difficulty in making this assessment in the absence of a program that addresses the appropriate adjustment/financing mix, and the inability of most members to meet this standard, the CFF has been little used in recent years. Moreover, CFF financing is not on concessional terms and it does not cover all exogenous shocks faced by low-income countries. In contrast, a PRGF window could offer financing on concessional terms and it could have greater flexibility to address sudden balance of payments needs, avoiding some of the difficulties of the CFF.

4. **In cases where a balance of payments need results from a natural disaster, subsidized Emergency Natural Disaster Assistance (ENDA) is now available, although subsidy resources are limited.** When the required adjustment to the natural disaster is substantial, however, support through the PRGF second window would be more appropriate, in view of its link with a suitable adjustment program. Where a Fund-supported program is not necessary, the subsidized ENDA remains a useful option.<sup>3</sup>

5. **Low-income members could also use credit tranche resources under a stand-by arrangement.** However, as noted at the March 2004 Board meeting, purchases on credit tranche terms are insufficiently concessional for most low-income member countries, even when subsidized. Also, the Fund has actively encouraged low-income countries to use PRGF rather than GRA resources, partly in view of the risk that increasing GRA exposure could lead to some of the difficulties observed in the 1980s. The provision of financing in the credit tranches would be subject to the policy of early repurchase expectations, which, if exercised, would further lessen the degree of concessionality.<sup>4</sup>

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<sup>3</sup> The [Trade Integration Mechanism \(TIM\)](#) provides additional assurances for countries faced with certain trade-related shocks. However, the TIM is available only as an add-on policy to a Fund arrangement in the GRA or the PRGF. Additionally, the [Emergency Post-Conflict Assistance](#) is available for countries emerging from conflict seeking to restore macroeconomic stability in a situation of insufficient capacity to develop and implement a comprehensive economic program that could meet the standards of upper credit tranche conditionality.

<sup>4</sup> [Review of Charges and Maturities: Policies Supporting the Revolving Nature of Fund Resources](#).

## II. PRGF WINDOW FOR BALANCE OF PAYMENTS NEEDS ARISING FROM SUDDEN AND EXOGENOUS SHOCKS

### A. Purpose and Basic Structure

6. **The new window within the PRGF Trust would be designed to provide financial assistance to meet balance of payments needs arising from sudden and exogenous shocks in PRGF-eligible member countries that do not have current PRGF arrangements.**<sup>5</sup> In line with Directors' concerns that such a safety net should be available on terms more concessional than subsidized credit tranche purchases, the second window would provide members with balance of payments support on the same financial terms as those of the PRGF window.<sup>6</sup> Arrangements under the second window would be one to two years in length, shorter than those under the standard PRGF window.<sup>7</sup>

### B. Qualification

7. **The PRGF second window would be aimed at assisting low-income member countries confronting a sudden and exogenous event requiring adjustment and temporary external financing.** The sudden and exogenous event (a shock)—such as a natural disaster, commodity price change, or conflict and crisis in neighboring countries—would have to have occurred prior to approval of an arrangement under the second window and be the primary source of the balance of payments problem. Given the difficulties involved in assessing the balance of payments impact and the duration of a shock, as well as the appropriate mix of adjustment and financing, the link between the balance of payments pressures and the shock would be assessed judgmentally rather than formulaically.<sup>8</sup> A protracted balance of payments problem, in contrast, would continue to be subject to

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<sup>5</sup> As of end-May 2005, there were 32 current PRGF arrangements (out of 77 PRGF-eligible member countries).

<sup>6</sup> Alternatively, credit tranche repayment maturities would allow PRGF Trust resources to revolve faster, and would be more consistent with the shorter-term nature of the balance of payments need; concessionalism could be slightly increased by lowering the rate of charge to zero.

<sup>7</sup> Approval of a standard PRGF arrangement, in contrast, requires that the Fund as Trustee be satisfied that the member has a protracted rather than an immediate balance of payments problem. To qualify for assistance, the member must present a three-year program of macroeconomic and structural adjustment derived from the member's PRSP.

<sup>8</sup> An alternative would be to broaden the qualification criteria to cover a broader range of balance of payment needs. This, however, would weaken the connection with shocks and potentially blur the distinction between the eligibility criteria under the two PRGF windows.

support under the standard PRGF window. Member countries could have an arrangement under only one PRGF window at a time.

**8. The second window would be appropriate for situations in which the member's policy response met the standard of upper credit tranche conditionality.** The authorities' policies would be supported by a Stand-by Arrangement (SBA)-type arrangement financed by the PRGF Trust. The policy program would be negotiated with staff. A current Policy Support Instrument (PSI) that is on track would facilitate access to this window.<sup>9</sup> Given the upper credit tranche standard of conditionality, performance under the second window could establish a track record of policy implementation, although this is not envisioned as a primary function of the instrument.

### C. Access Guidelines

**9. Access norms for the second window could be set broadly in line with the current access norms for standard PRGF arrangements.**<sup>10</sup> While the qualification criteria should determine which PRGF window is applicable, similar access norms will reduce bias in making that decision. However, the purpose of the proposed facility provides little justification for tapered access norms, because the size of the shock and the balance of adjustment and finance should not depend on the number of previous PRGF arrangements.

**10. Access under the second window could be considered in light of the intended catalytic role of Fund financing and past use of Fund resources.** The Fund's catalytic role would generally call for low access relative to the scale of need. As subsidized ENDA and even PRGF Trust resources are relatively expensive for many low-income countries, members would be encouraged to seek—and donors to provide—additional, more concessional, resources to meet the identified balance of payments need arising from the shock.<sup>11</sup> However, specific features of low-income countries facing shocks suggest that

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<sup>9</sup> An accompanying paper on [Policy Support and Signaling in Low-Income Countries](#) proposes the PSI as a new signaling instrument for low-income countries ([PIN No. 05/145, October 14, 2005](#)).

<sup>10</sup> The Fund has established three-year access norms of 90 percent and 65 percent of quota (equivalent to 30 percent and 22 percent of quota, on an annual basis) for first- and second-time users of PRGF resources, respectively. More tapered access norms have been established for successive PRGF arrangements: 55 percent (18 percent, on an annual basis); 45 percent (15 percent, on an annual basis); 35 percent (12 percent, on an annual basis); and 25 percent (8 percent, on an annual basis) of quota for third, fourth, fifth, and subsequent PRGF arrangements, respectively.

<sup>11</sup> Subsidized ENDA carries a grant element of 19 percent, while PRGF terms imply a grant element of 32 percent. These calculations assume a discount rate of 5 percent, which is

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flexibility will be required. First, immediate external financing can have a strong impact in mitigating both the direct and long-lasting secondary effects of shocks in low-income countries.<sup>12</sup> Second, catalysis can be relatively slow, because donors typically cannot reorient aid flows quickly. Together, these features suggest that frontloading external financing from the Fund can be an efficient intertemporal reallocation of resources, in the anticipation of more concessional financing from other sources.

11. **Access under the second window should also be viewed against the background of past Fund support for shocks in low-income countries.** In recent years, augmentations of PRGF arrangements have been approved for just under a quarter of all three-year PRGF arrangements. The median size of augmentation has been 10 percent of quota, with a minimum and maximum of 4 percent and 37 percent of quota respectively. In the 14 cases of augmentation of PRGF arrangements for natural disasters and terms of trade shocks for which staff provided an estimate of the direct impact of the shock, augmentation averaged 12 percent of quota, while the average impact of the shock on the balance of payments was estimated to be about 70 percent of quota. Emergency assistance for natural disasters can amount to 25 percent of quota (though larger amounts can be made available in exceptional circumstances).

12. **On balance, a reasonable norm for annual access under the second window is 25 percent of quota.** This proposed guideline is higher than the average of past PRGF augmentations and in line with access under the Fund's emergency assistance policy. Nevertheless, it is less than the estimated average impact of various shocks, which is consistent with the intended catalytic role of Fund financing and with the need for more concessional donor assistance. This norm would also limit use of scarce PRGF resources. Within this guideline, access under the second window would be determined on a case-by-case basis. Considerations in setting the level of access in a particular case would include the size of need for temporary shock-related financing and previous use of PRGF resources.<sup>13</sup> Separately, staff would also propose that outstanding balances under the second window be limited to 50 percent of quota, given the scarcity of PRGF Trust resources. Access beyond 50 percent could be made available in exceptional circumstances.<sup>14</sup> In line with the access

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consistent with the average long-term market interest rate since the initiation of the ESAF/PRGF.

<sup>12</sup> [\*Fund Assistance for Countries Facing Exogenous Shocks\*](#).

<sup>13</sup> Access under standard PRGF arrangements is based on a set of general guidelines that include a member's balance of payments need; the strength of its adjustment effort; its outstanding use of Fund credit and the record of such use in the past; and ability to repay the Fund. These guidelines would also apply for arrangements under the second window.

<sup>14</sup> In comparison, the Executive Board has capped access under a three-year PRGF arrangement at 140 percent of a member's quota (185 percent of quota in exceptional

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policy, use of Fund resources under the second window could be taken into account when determining the level of access under subsequent PRGF arrangements.

13. **Members with a PSI on track would be presumed to have easier access to the second window.**<sup>15</sup> The economic program supported by the PRGF second window would be directly drawn from the PSI-supported program, with additional adjustments limited to those necessary to correct the additional balance of payments need arising from the exogenous shock. In contrast, for a member without a PSI on track, the program discussions would need to cover the full range of issues associated with upper credit tranche conditionality.

14. **Members with an existing PRGF arrangement in place have access to PRGF augmentation**, which remains for them the most appropriate form of Fund financing when facing increased balance of payments needs as a result of exogenous shocks.<sup>16</sup> An existing PRGF arrangement provides a framework within which the policy response to the shock can be structured, including measures to ensure adequate expenditures to protect those most vulnerable to the adverse impacts of shocks.

15. **Principles similar to those applicable under the new guidance on blending use of PRGF and GRA resources could also apply to use of the PRGF second window.**<sup>17</sup> For those members subject to blending, the annual access norm for PRGF resources under the

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circumstances), and under the CFF at 45 percent of quota for either an export shortfall or a cereal import excess, or a combined limit of 55 percent of quota. No formal limits on ENDA credit have been specified although, in practice, amounts have been limited to 50 percent of quota.

<sup>15</sup> Because access to Fund resources would require that the Executive Board adopt a separate decision concerning the use of resources, there would be no automatic access to Fund resources for members with a PSI. Nevertheless, the implementation of a PSI-supported program with upper credit tranche conditionality would facilitate this process as it would eliminate the time normally required to design such a program and demonstrate that it can be successfully implemented.

<sup>16</sup> A guidance note on access under the PRGF, including principles for PRGF augmentation, was issued to the Board: [\*Operational Guidance Note on Access Under the Poverty Reduction and Growth Facility\*](#).

<sup>17</sup> The March discussion indicated the use of PRGF/EFF blends if (i) the member's per capita income exceeds 75 percent of the prevailing IDA operational cutoff (currently US\$895), or (ii) the member had recent or prospective medium- or long-term borrowing from private capital markets or the nonconcessional windows of official bilateral and multilateral lenders. This would currently cover 27 of the 77 PRGF-eligible members (See Box 5 of the paper listed in footnote 1).

second window would be 12½ percent of quota, with any additional financing needs arising from the shock being met from the GRA (under an SBA). The total outstanding balance on PRGF resources under the second window would be limited 25 percent of quota. This implies that, for PRGF/GRA blend countries, the effective grant element in total financing would be smaller than that associated with PRGF terms.

#### **D. Conditionality**

16. **Conditionality in programs supported by the PRGF second window would have the same standard and purpose as in an upper credit tranche arrangement.** The program supported by the PRGF second window would be designed primarily to adjust to the immediate balance of payments need. Less emphasis would be expected on structural reform than in a three-year PRGF arrangement, except insofar as structural issues may be important for adjustment to the shock. In view of the centrality of poverty issues in these member countries, use of the facility would require that the poverty reduction strategy (PRS) process be underway, with at least an interim poverty reduction strategy paper (I-PRSP) in place. In those cases, expected to be rare, in which the preparation of an I-PRSP would unduly delay access under the second window, preparation of an I-PRSP could take place as a condition for a subsequent review.<sup>18</sup> Where an existing PRSP has adequate contingency plans for shocks, these plans should form the basis of the macroeconomic framework. Even in the absence of such contingencies, the design of the program supported by the second window should give due consideration to the need to protect the poor, often those most adversely affected by shocks.

17. Finally, consistent with current practice, it is proposed that the policy on safeguards assessments would also apply to use of resources under the second window.

#### **E. Modalities**

18. **The modalities of the PRGF second window would be designed to facilitate quick access and to ensure implementation of the appropriate adjustment to the exogenous**

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<sup>18</sup> Some 53 of 77 PRGF-eligible members currently have either an I-PRSP or a full PRSP, and the majority of the remaining countries have a PRS process underway or a draft I-PRSP under preparation. Some countries who have not initiated the PRS process have available an alternative development strategy document—such as the Transitional Results Matrix supported by the World Bank in several low-income countries under stress (LICUS)—that can help to identify priorities and that can be made consistent, relatively quickly, with the guidelines set out in [Annex VI of Poverty Reduction Strategy Paper—Progress in Implementation](#). These guidelines envision an I-PRSP prepared primarily from existing documents and analyses—such as a macroeconomic framework, previous poverty assessments, and current development strategies. The proposed PSI guidelines also require that a PRS process be underway.



**shock, while ensuring adequate safeguards for the use of PRGF Trust resources.**

Following an expression of interest, the member and Fund staff would conduct discussions on the member's economic and financial policies. Where a PSI is on track, the focus would be on the additional adjustment necessary to correct the new balance of payments need arising from the exogenous shock. In other cases, the staff would need to assess more broadly whether the proposed policies, including the adjustment measures, meet the upper credit tranche conditionality standard. The authorities would send the Managing Director a letter of intent (LOI) setting out the authorities' commitments in support of the request for financing assistance. Based on the Managing Director's recommendation, the Executive Board would consider approval of the request, provided that the members' policies, as described in the LOI, met the appropriate standard. Performance criteria, program reviews, and disbursements would normally take place on a quarterly basis. A representation of actual balance of payments need would be a condition for disbursements under the second window.<sup>19</sup> In view of the Fund's catalytic role and the potential value of rapid financing in the event of shocks, it is likely that the balance of payments need may be frontloaded. In this context, frontloading the pattern of disbursements might be appropriate and would be considered in individual cases. Consistent with the rules concerning the PRGF window, publication of the member's LOI, the staff report, and a press release containing the Board's assessment, would be voluntary but presumed.

#### **F. Staff Resource Implications**

19. **The establishment of the second window within the PRGF Trust is likely to generate additional annual resource costs equivalent to 4½ staff years.** This estimate is consistent with (i) projections provided in the accompanying papers; (ii) historic rates of PRGF augmentation (providing the estimate for the probability of a shock likely to generate a balance of payments problem); and (iii) indicative rates on staff years required for program-intensive work (as provided by OBP). During the period 2005-2011, ten members are considered likely to access the second window within the PRGF Trust and to generate a need for additional staff resources.<sup>20</sup> Historically, augmentations for shocks have occurred in

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<sup>19</sup> Disbursements eventually determined to have been received in the absence of a balance of payments need would be expected to be repaid within a specified period of time.

<sup>20</sup> An accompanying paper estimates that, among the 77 PRGF-eligible countries, 16 are not expected to request a new standard PRGF arrangement during the period 2005-2011. In the event of an exogenous shock, these members are likely candidates for access under the second window of the PRGF Trust. As indicated in the accompanying paper on [Policy Support and Signaling in Low-Income Countries](#), 5 of these 16 members are expected to request a PSI—in which case, a request for financing under the second window of the PRGF would not require additional staff resources. Finally, another of the 16 members is considered unlikely to request access under the second window of the PRGF, leaving the group of likely candidates at 10. Although some members currently with a standard PRGF arrangement may also request access under the second window during 2005-2011 (depending on the timing of

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approximately one quarter of ESAF-PRGF arrangements, or at the rate of just over 8 percent per year. OBP estimates that, relative to surveillance mode, a use of Fund resources (UFR) program typically requires an additional 2.8 staff years. Further assuming that the typical program under the second window of the PRGF Trust would be 2 years in length, these estimates indicate that 0.8 arrangements are likely to be requested per year (0.08 probability  $\times$  10 countries), and that the equivalent of an additional 4½ staff years are likely to be necessary per year (0.8 arrangements  $\times$  2.8 staff years  $\times$  2 years in length).

### G. Amending the PRGF Trust Instrument

20. **The establishment of a PRGF second window within the PRGF Trust would require amendments to the PRGF Trust Instrument.** This requires a decision by the Executive Board adopted by an 85 percent majority of the total voting power and the consent of all contributors of loan and subsidy resources to the PRGF Trust, as well as the consent of all contributors to the PRGF-HIPC Trust, other than contributors of resources earmarked only for debt relief under the HIPC Initiative.<sup>21</sup> Amending the PRGF Trust Instrument to include a second window, along with a number of consequential changes, would require extensive amendments to the PRGF Trust Instrument.<sup>22</sup> In essence, the PRGF Trust would finance two distinct windows, one to provide assistance in support of members' medium-term adjustment and reform programs, and the other to provide assistance to the same eligible members when affected by shocks. There are, however, no technical obstacles to the required modifications. A draft decision to effect the necessary amendments to the PRGF Trust would be submitted to the Board for further discussion or adoption on a lapse-of-time basis following the Board's discussion of the proposals contained in this paper.

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the end of that arrangement and the shock), it is similarly possible that some members included in the group of likely candidates would, in the case of a shock, opt for a standard PRGF arrangement instead of access under the second window. On balance, the working assumption of 10 likely candidates during the period 2005-2011 appears reasonable.

<sup>21</sup> Thus, this would require the consent of 17 contributors of loan resources to the PRGF Trust, 43 contributors of subsidy resources to the PRGF Trust, and 85 contributors of subsidy resources to the PRGF-HIPC Trust.

<sup>22</sup> The purposes of the PRGF Trust are set out in Section I, paragraph 1 of the PRGF Trust Instrument: "The Trust shall assist in fulfilling the purposes of the Fund by providing loans on concessional terms to low-income developing members...in order to support programs to strengthen substantially and in a sustainable manner their balance of payments position and to foster durable growth, leading to higher living standards and a reduction in poverty." The current eligibility conditions, as set out in Section II, include that: "This assistance shall be committed...in support of a three-year macroeconomic and structural adjustment program presented by the member;" and "Before approving a three-year arrangement, the Trustee shall be satisfied that the member has a protracted balance of payments problem..."

### III. CONCLUSIONS

21. **A second window within the PRGF Trust could provide concessional assistance to low-income countries facing sudden and exogenous shocks resulting in a need for adjustment and temporary Fund financing.** It would provide a useful complement to the proposed PSI—as access to the second window would be facilitated by a PSI which is on track—and a financial safety net for members that might wish to exit continuous PRGF-supported program engagement. The required modifications to the PRGF Trust Instrument are substantial but technically feasible. The use of PRGF resources to finance shocks faced by low-income countries is consistent with the Fund’s support for these members, closing a gap in the concessional instruments available to low-income members. The absence of such an option may encourage some members to seek successive PRGF arrangements when an exit might otherwise be desirable. There is a risk that members might use the second window when their balance of payments problems and adjustment needs would be better addressed under the conditions of a standard PRGF arrangement. The proposed design of the PRGF second window is intended to address this issue, including through clear eligibility requirements.

### IV. ISSUES FOR DISCUSSION

22. The paper outlines a proposal for a second window in the PRGF Trust aimed at assisting low-income members confronting immediate balance of payments needs arising from sudden and exogenous shocks—such as natural disasters, commodity price changes and conflicts and crises in neighboring countries—rather than protracted balance of payments difficulties. Do Directors agree that:

- PRGF augmentation remains an effective tool when a PRGF arrangement is in place, but the needs of other PRGF-eligible members facing shocks with low capacity to bear debt have not been fully addressed hitherto?
- a second window within the PRGF Trust could play a useful role in allowing the Fund to assist low-income members without a standard PRGF arrangement facing shocks, and that it would provide a useful complement to the proposed PSI because, for members with a PSI on track, the economic program would be directly drawn from the PSI-supported program with additional adjustments limited to those necessary to correct the immediate balance of payments need arising from the shock?
- the facility should be structured as suggested in paragraphs 6-18? In particular:
  - qualification would depend on the existence of a balance of payments need arising from sudden and exogenous shocks and requiring adjustment and temporary Fund financing;

- on balance, a reasonable norm for annual access is 25 percent of quota, with a cumulative limit of 50 percent of quota, although amounts above this limit could be made available in exceptional circumstances; and
- conditionality in programs supported by the PRGF second window would have the same standard and purpose as in an upper credit tranche arrangement?