INTERNATIONAL MONETARY FUND

# Review of the Flexible Credit Line and Precautionary Credit Line

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In consultation with other departments
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## EXECUTIVE SUMMARY

***Background***. With the creation of the Flexible Credit Line (FCL) and Precautionary Credit Line (PCL), the Fund's GRA toolkit was overhauled to address gaps in the Fund's crisis prevention and resolution toolkit. The innovative and flexible nature of the new instruments was meant to reduce stigma from using Fund resources, underpinning confidence in its users amid stressed market conditions. Yet, there have been a limited number of members with these arrangements. Using a variety of methodological tools, this review assesses experience with the instruments, reflects on the appropriateness of their design, and recommends refinements to enhance their effectiveness.

***Objectives***. It was expected that the FCL and PCL would help bolster confidence and moderate balance of payments (BoP) pressures for members availing themselves of, or expected by markets to qualify for, the instruments. The review suggests that this has indeed been the case, even under difficult global conditions, with spreads and exchange rate volatility falling for users. There is also evidence that other members perceived by markets as FCL "qualifiers" benefited indirectly. This provides some support for the view of members using the instrument that it has been a success.

***Substitutability with reserves***. Experience with the FCL suggests that users have obtained successor arrangements to bolster their defenses amid very adverse external conditions. At the same time, some members have indicated skepticism that FCL/PCL resources could credibly complement reserves, given unpredictability in qualification. The review suggests that these instruments should not be viewed as permanent reserve substitutes, although they can still help mitigate excessive reserve buildup by providing qualifying countries with an alternative to self-insurance. Qualification predictability can improve over time with experience with the use of these instruments, but only a system of ongoing pre-qualification—which has not found support among the membership in the past—would overcome such concern.

***Access***. The review shows that the assumptions for the shock scenarios used to underpin access decisions differed across arrangements in a manner that complicates access comparisons. It therefore suggests an approach that helps enhance transparency of access decisions, facilitating comparison and evenhandedness across arrangements as well as comparing minimum reserve levels under adverse scenarios with relevant metrics. At the same time, access decisions would continue to be based on country-specific estimates for actual and potential BoP need.

***Instrument structure***. The review covers key aspects of the FCL-PCL structure:

- **Qualification**. Although some members have called for increased predictability, qualification assessments to date appear to have been broadly appropriate. Nevertheless, going forward they could benefit from placing more emphasis on qualitative and forward-looking elements (the member's ability to deal effectively with shocks, which underpins the absence or focused use of ex post conditionality in these instruments, is only in part captured by quantitative measures of policy performance as these tend to be mostly backward looking). The use of very recent Article IV reports (and other tools, such as very recent FSAPs) wherever possible would also help focus qualification decisions.

- **"Drawing" PCL**. PCL arrangements can, under current rules, only be approved where the member does not have an actual BoP need at the time of approval. Allowing for PCL arrangements to be approved when the member faces an actual BoP need would make for a more coherent financing toolkit and allow more flexibility in response to members' needs. Other safeguards under the PCL decision—ex ante and focused ex post conditionality, relatively short purchase right duration, capped access, and phasing of access in longer arrangements—are seen as broadly adequate and qualification standards sufficiently strong to provide a clear distinction from SBAs.

- **Duration flexibility**. More flexible PCL duration—specifically six-month PCL arrangements—would allow the Fund to respond better to members' liquidity needs of short duration, particularly of crisis bystanders facing sudden external shocks during periods of heightened stress and contagion.

- **Commitment fees**. The review discusses whether changes to the current upward-sloping level-based commitment fee schedule are needed to deter unnecessarily high and protracted precautionary access and contain related liquidity risks to the Fund. A steeper, but more graduated, fee schedule is considered as a possible future reform. On balance, the findings do not point to a strong case at present for reforms in this area, but the issue could be revisited as more experience is gained.

## I. INTRODUCTION[1]

1. **The GRA toolkit was reformed in recent years to address gaps in the Fund's crisis prevention and resolution toolkit**. In March 2009, the Flexible Credit Line (FCL) was created in combination with other reforms including changes to conditionality in Fund-supported programs;[2] the Precautionary Credit Line (PCL) was subsequently created in August 2010 concurrently with the approval of further changes aiming at enhancing the flexibility of the FCL.[3] The overall aim of these reforms was to provide more flexible instruments in the credit tranches to address all types of balance of payments (BoP) needs—either for contingent or actual financing (FCL), or for contingent financing only (PCL). The FCL and PCL were expected to strengthen both crisis prevention and mitigation by allowing for the approval of Fund arrangements that could play a complementary role to members' reserves and other regional and international backstops.

2. **To allow the flexibility needed under these reforms, the new instruments were restricted to members that met certain qualification requirements**, namely very strong (FCL) or sound (PCL) economic fundamentals and institutional policy frameworks, track records in policy implementation and commitment to maintaining these policies (see Box 1). Given these rigorous qualification criteria, access was allowed to be high, phasing was eliminated (FCL) or frontloaded (PCL), and conditionality was streamlined and mostly ex ante. As a result, perceived stigma associated with these new instruments was expected to be much lower than for traditional Fund instruments. More generally, the new instruments embodied a new approach of distinguishing Fund instruments based on the strength of members' policies, institutions and track records, rather than on the nature of their BoP need; they also marked a return to use of the ex ante conditionality that had been a feature of Fund financing in earlier years.

3. **These instruments have, to a large extent, fulfilled these roles**. Specifically, the new instruments have led to a quality gradation in the GRA lending toolkit. Arrangements under the both the FCL and the PCL have provided large upfront access, tailored to members' needs. The FCL also provided important signals of members' strength, as demonstrated by the important benefits they received in terms of lower spreads and exchange rate volatility.

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[1] Paper prepared by an interdepartmental team led by D. McGettigan and N. Porter (SPR) and comprising K. Guo (APD), M. Rossi and R. Rozenov (both FIN), K. Christopherson, D. Eastman, A. Giddings, K. Kwak, Y. Liu, G. Rosenberg (all LEG), and R. Bi, T. Bui, M. Goretti, I. Halikias, B. Kelmanson, S. Lanau, R. Llaudes, K. Magnusson, T. Miyoshi, M. Pant, H. Qu, J. Roaf, and F. Salman (all SPR), with overall guidance from T. Krueger (FIN), L. Giorgianni (SPR), and R. Weeks-Brown (LEG).

[2] The Review of Conditionality is ongoing, and is expected to be completed in early 2012.

[3] These reforms result from a sequence of Board papers, starting with *Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options*, and then including *GRA Lending Toolkit and Conditionality—Reform Proposals*, *The Fund's Mandate—The Future Financing Role: Reform Proposals*, and *The Fund's Mandate—The Future Financing Role: Revised Reform Proposals*.

4. **Despite the innovative and flexible nature of the FCL and PCL, there have, to date, been a limited number of members using these arrangements**. The relatively limited interest[4] likely reflects ongoing concerns regarding stigma, a preference for self insurance through reserves, as well as some other issues (e.g., qualification, access, flexibility, and subjectivity) that we will consider in this review. Nevertheless, total commitments under the FCL and the PCL stand at around SDR 71 billion (more than US$110 billion)—a large amount. Despite the limited number of cases, some lessons—including those related to the benefits of the instruments, access and fees—seem relatively clear. But some others issues—including stigma—can only be resolved as the number of arrangements increases, although concerns about stigma may also be driven by the indication of a financing need, or domestic political considerations that have more to do with perceptions of the Fund's legitimacy than with the design of the instruments per se.

5. **This review of the FCL and PCL—accelerated in response to requests from the Executive Board—assesses experience with the instruments and recommends further evolutionary changes in the design and application of the existing framework**. Based on the experience with current FCL and PCL arrangements, the review identifies further adaptations in design that may enhance their effectiveness, thereby further strengthening the GRA financing toolkit, with the main recommendations summarized in Box 2. Several of these recommendations feed into the companion paper, *The Fund's Future Financing Role: Reform Proposals on Liquidity and Emergency Assistance*. The review also covers topics such as commitment fees and access, which are also relevant for other types of GRA arrangements, including SBAs. The review also seeks to clarify issues in some controversial areas, including differing views about the reserves-like role of these new instruments, and the flexibility needed.

6. **The review employs a wide variety of methodological tools**. It uses case studies and, given the limited number of FCL and PCL arrangements to date, a variety of analytical work. The review is also informed by the findings of interviews with senior staff involved in past and current arrangements and of a survey of country authorities conducted through Executive Directors' offices and with market participants.

7. **The rest of the paper is organized as follows**. Section II attempts to provide a new analysis of the impact of the new instruments. Section III discusses whether the FCL and PCL are close reserve substitutes. Section IV reviews access and exit issues. Section V reviews the design of the new instruments. This includes qualification; flexibility; and commitment fees. Section VI summarizes and concludes. The paper also includes, in Annex I, detailed case studies of the arrangements to date for Colombia, Mexico, and Poland (all FCLs) and for FYR Macedonia (PCL). Annex II presents the survey responses.

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[4] As discussed below, there have been expressions of interest for the new instruments from other members that have not been brought to conclusion for various reasons.

## Box 1. Design of FCL and PCL

Both the FCL and PCL provide access to credit lines that can be drawn to respond to external financing shocks. They are aimed at members that have demonstrated very strong (FCL) or sound (PCL) economic fundamentals, institutional policy frameworks and policies. Given the differences in the strength of qualifiers to each of these instruments, they differ in the key design features (in terms of BoP need, length of arrangements and purchase rights, access, and conditionality) applied.

- ***Qualification***. To qualify for the FCL, members must have very strong economic fundamentals and institutional policy frameworks, and be implementing and have a sustained track record of implementing, very strong policies. The qualification standards are somewhat lower for the PCL, but still require sound fundamentals and policy frameworks, with a track record of implementing sound policies (and in both cases a commitment to maintaining the relevant policies in the future is required also). Beyond the absolute standard—"sound" versus "very strong"—qualification differs in other more subtle ways. Both require an assessment of qualification criteria in five areas—external position and market access; fiscal policy; monetary policy; financial sector soundness and supervision; and data adequacy, with PCL qualifiers needing to have **strong performance** in three areas, without substantial underperformance in any. In addition, PCL qualifiers cannot face any of the following circumstances: sustained inability to access the market; need for large macroeconomic or structural adjustment; unsustainable public debt; and widespread bank insolvencies. The FCL qualification criteria were "designed to enable a member in most cases to "self-select—i.e., determine with a high degree of confidence whether it would qualify for an FCL arrangement."[1/]

- ***Length***. FCL arrangements may be approved for either one or two years. PCL arrangements may be approved for periods between one and two years. Arrangements under both instruments may be cancelled by the member at any time, and, once fully drawn, the arrangements expire automatically.

- ***Access and Phasing***. During the reform of the FCL in 2010 the informal cap on FCL access was eliminated. Unlike the FCL, the PCL has a "duration-based" access approval limit and a hard overall access cap for the use of the instrument: (i) a limit of 500 percent of quota for a one-year arrangement at the time of its approval, which can be augmented subsequently up to an overall cumulative cap of 1,000 percent of quota subject to the completion of a scheduled or ad hoc review, and (ii) an overall cumulative cap of 1,000 percent of quota, with arrangements between one and two years phased to provide up to 500 percent of quota upon approval of the arrangement, and remaining amounts at the beginning of the second year subject to completion of the relevant six-monthly review (with the potential for rephasing and/or augmentation to bring forward access subject to completion of a scheduled or ad hoc review by the Board).

- ***Conditionality and Review***. As with other GRA arrangements, both the FCL and PCL have conditionality. However, reflecting the quality of qualifying countries, the FCL involves mainly ex ante conditionality, although there is a review after 12 months, to confirm continued qualification for FCL arrangements with a two-year duration. For the PCL, conditionality is both ex ante (qualification) and ex post, although the latter is lighter than that normally used for instance in SBAs. In PCL arrangements, members commit to a set of policies, are subject to standard continuous performance criteria and indicative targets aimed at addressing their remaining vulnerabilities identified during the qualification process, and reviews are held semi-annually. For the PCL, members may also be subject to additional performance criteria where required under the Guidelines on Conditionality (i.e., where PCs are critical to the program's goals or to the monitoring of implementation) and prior actions. The PCL is subject to the standard Safeguards Assessments and the safeguards procedures applied for the FCL appear to have been effective in the context of this facility.

- ***Terms***. As windows in the credit tranches, these arrangements are subject to the same periodic charges, surcharges, commitment fees, and repurchase period (3¼ to 5 years) as the SBA. Commitment fees rise with the extent of committed funds (15 basis points for commitment up to 200 percent of quota, then 30 basis points for access between 200 and 1,000 percent of quota, and 60 basis points on higher access) for all precautionary arrangements.

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1/ GRA Lending Toolkit and Conditionality—Reform Proposals.
2/ Safeguards Assessments—Review of Experience.

**Box 2. Summary of Principal Recommendations and Findings**

A. Delivery on Objectives?

1. The PCL and FCL have had a positive impact on the perceived crisis risk of recipients, and have had positive spillovers to other members perceived by markets as FCL "qualifiers."

B. Close Reserves Substitute?

2. The FCL and PCL instruments are best suited to provide insurance in periods of heightened risk.

C. Access and Exit

3. More transparency is recommended in practice in determining access to facilitate comparison and evenhandedness of access decisions across arrangements. Recommendations: (i) greater attention in presenting the link between access and the size of actual or potential BoP needs in individual cases; (ii) consider tools to provide comparability in the choice of adverse shocks to underpin access scenarios, while also taking into account country-specific factors; and (iii) cross-check programmed reserves against standard adequacy metrics.

4. No need for further changes to the current FCL access rules. PCL to allow six-month arrangement with limited access.

5. Further discussion and transparency about exit prospects, especially at the outset of an arrangement would underpin realistic exit expectations.

6. Although not pressing, reforms to commitment fees may also help underpin exit expectations, and limit incentives for potential requests for arrangements with "unnecessarily high" access.

D. Qualification

7. More focus needed on qualitative and forward-looking qualification criteria.

8. Very recent completion of Articles IVs and FSAPs (and, where appropriate, ROSCs) highly recommended, to the extent possible, taking into account logistical and resource considerations.

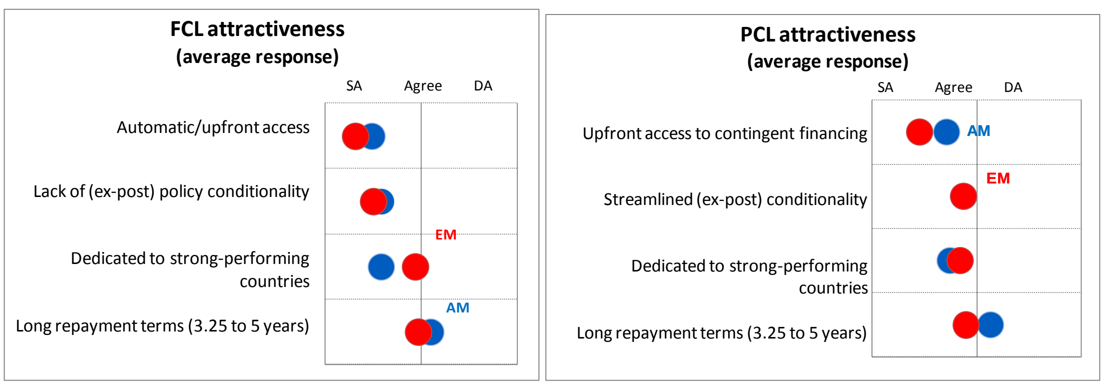
E. Instrument Structure

9. PCL arrangements approved where member has an actual BoP need at the inception of the arrangement would allow the Fund to respond more flexibly to member needs, where countries meet all other PCL qualification requirements.

10. More flexible duration—specifically six-month PCL-type arrangements—would allow the Fund to proactively channel liquidity to crisis bystanders during periods of heightened stress, thus enabling the Fund to play a more effective role in stemming contagion.

## II. Impact of the FCL and PCL: Have They Delivered on Their Objectives?

8. **A litmus test of the success of the FCL and PCL is whether they had a positive impact on market confidence in qualifying members, a key objective of the new instruments** (Box 3). Introduced in a crisis environment, it was expected that both the FCL and PCL would help bolster confidence and moderate BoP financing pressures for members availing themselves of the new instruments. The Fund's Mandate—Future Financing Role, pp.11−12, shows the positive effect that the introduction of this instrument, just preceding the G-20 London summit announcement on the plan to boost IMF resources, had in turning around market sentiment toward emerging market economies during the spring of 2009. Survey respondents, both from the public and private sector, also agreed that the FCL had been a key element in an enhanced and strengthened IMF lending tool kit.[5] [6] Consistent with this expectation, investment bank reports at the time of inception of the FCL highlighted the likely positive impact of these new instruments. They underscored the larger size and more frontloaded financing provided, alongside more streamlined conditionality, and argued that the new instruments would support the financial markets in the recipient countries.[7]



Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.
"SA" denotes strongly agree, "DA" denotes Do not agree

[5] There was less agreement on whether the PCL had fulfilled expectations, both due to the limited experience to date as well as greater disagreement over its appropriate role and intended recipients compared with other Fund lending instruments.

[6] Survey results are presented in Annex II.

[7] In addition to the actual recipients of FCL arrangements (Mexico, Poland, and Colombia), investment bank analysts identified a small number of other countries as possible FCL qualifiers soon after the creation of the facility. An example of such a report is Barclays Capital, 30 March 2009, "New and redesigned IMF facilities: Implications for EM." Without implying any endorsement of these countries' qualification, they are used below as a comparator group in examining market responses to FCL and PCL decisions.

**Box 3. Analysis of the impact of FCL-PCL on Spreads and Exchange Rates**

**This review first employs an event study-based analysis to assess whether the FCL-PCL yielded their intended benefits**. A two-stage approach is taken: (i) global factors are first stripped from individual country spreads, and (ii) the approach then focuses on a relatively short time span around key dates (e.g. FCL approval).

For the **first stage**, the following regression is estimated to strip out the global factors in each country's (*i*) spreads.

$$EMBI_{i,t} = \alpha_i + \beta_i EMBI_{Global,t} + \varepsilon_{i,t}$$

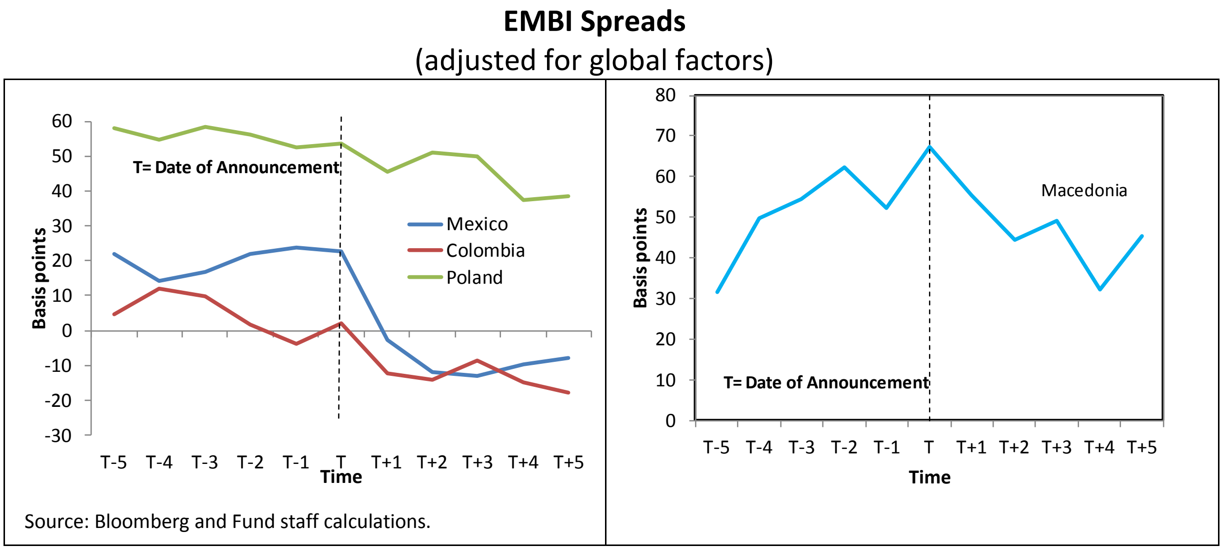
The left hand side variable is external spreads of Mexico, Poland, and Colombia regressed on the global average of emerging market spreads of the same maturity. For Macedonia spreads are calculated through subtracting the benchmark (five year) Eurobond from German Bunds with same maturity. $\alpha$ and $\beta$ are country specific constant and slope coefficients. Residuals are represented with $\varepsilon$, which identifies spreads that would only be expected to move due to country-specific factors.

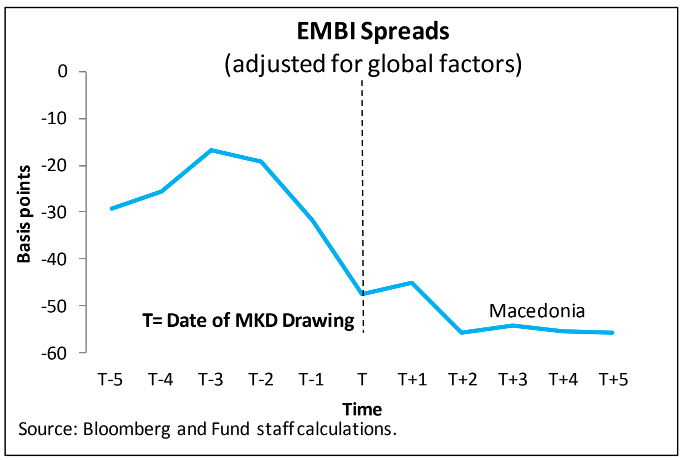
The **second stage** focuses on the five-day window for the resulting spreads immediately before and after the key date, i.e., country announcement/Board approval for the FCL. This short window length is typical in event study methodology.

9. **We find evidence suggesting that the FCL and PCL boosted confidence and moderated BoP pressures for recipient countries and produced positive spillovers for other countries deemed by market participants as "FCL-qualifiers."** Both spreads and exchange rate volatility fell around the time of new PCL/FCL arrangements, as did the conditional probability of distress in member countries deemed by markets as "qualifiers" that did not approach the Fund once FCL arrangements were approved for Mexico and Poland and, to a lesser extent, Colombia.

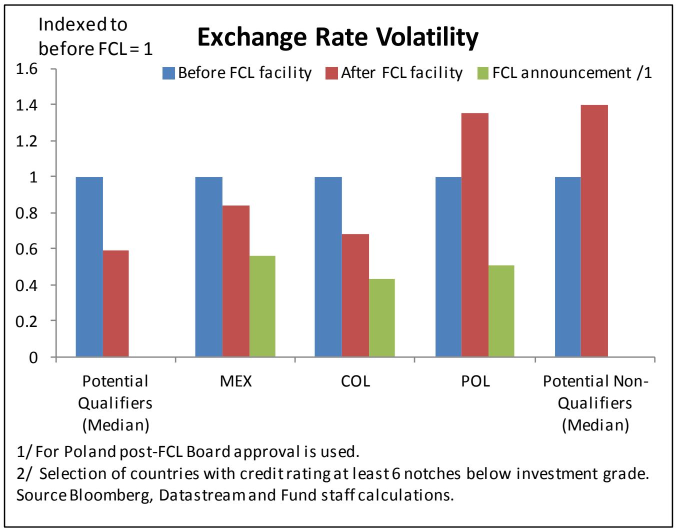
- **Spreads**. A reduction in spreads was observed for actual FCL-PCL users around the time of their announcements of interest in arrangements under the FCL or PCL. Abstracting from the global component of spread changes, to focus on the country-level effect, it can be seen that the announcement of Mexico and Colombia's interest in the FCL and Macedonia's in the PCL resulted in large declines in spreads (see chart).[8] Following FYR Macedonia's drawing on its PCL arrangement, spreads continued their decline, suggesting a possible additional reduction in perceived risk—through a relaxation of FYR Macedonia's financing constraint—when the insurance was ultimately used.

[8] The FYR Macedonia external bond market is, however, highly illiquid, limiting the information that can be gleaned from this market.

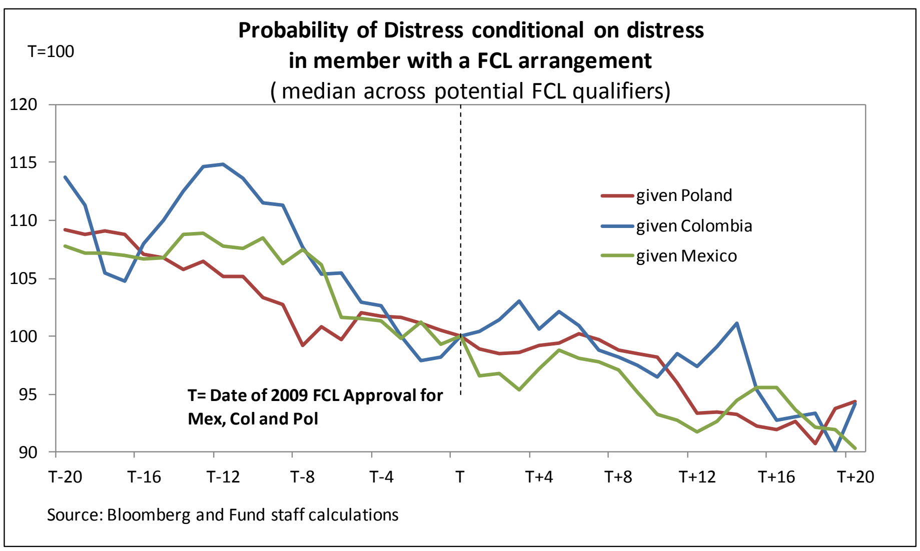



- **Exchange rate volatility**. For FCL recipients, and in contrast to the case for spreads, exchange rate volatility—measured by the 20-day standard deviation before and after the impact date—actually fell around the time of the creation of the new instruments (see chart). Moreover, FCL recipients observed a further reduction in volatility (almost by half) after their declaration of interest and/or Board approval of an FCL arrangement. While the extent of volatility may be affected by intervention, none of the FCL cases undertook large-scale intervention after the approval of the FCL arrangement. By contrast, exchange rate volatility increased over the same period for countries with credit ratings at least six notches below investment grade (likely non-qualifiers).



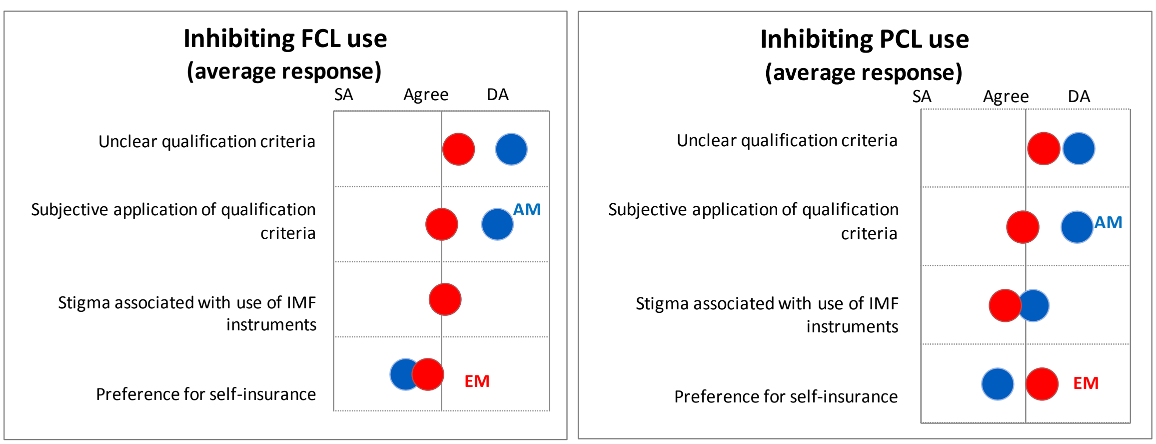

10. **The approval of FCL arrangements also appears to have had beneficial spillover effects.**[9] Specifically, approval of each of the first FCL arrangements was associated with an ongoing reduction in the conditional probability of distress (CoPoD) in the set of members deemed by markets as potential FCL qualifiers, conditional on "distress" in Mexico and Poland, and, to a lesser extent Colombia.[10]




[9] Survey respondents underscored the need for analysis of the crisis prevention effects of the FCL. Since the chart in paragraph 10 reports *conditional* probabilities of distress, global factors are automatically controlled for.

[10] Possible effects are measured by averages of estimated CoPoDs in the set of potential FCL qualifiers identified by investment banks, conditional on distress in Colombia, Mexico, and Poland, using sovereign CDS spreads. If the CoPoD in a given sovereign increases, it means that the market assigns a higher probability that distress in Colombia, Mexico, and Poland would be followed by distress in that sovereign. The opposite also holds.

11. **Survey results provide some indication of why, despite these benefits, there has been limited demand for these new instruments**. At the outset, it should be recalled that the universe of countries seen as possible qualifiers for these instruments was limited given the very high qualification bar. Even so, one factor that may have limited demand is positive externalities accruing to the members that see themselves (or investment banks see) as "qualifying" for the FCL, mitigating the need to request an arrangement—with this effect being larger the clearer the perception that the member qualifies for such an instrument. Another may be that members are unaware of how large the benefits have been to users. Both survey and interview findings also suggest that other factors may have been at play. A key objective of recent reforms was to reduce the stigma associated with Fund arrangements, but results from the survey as well as internal interviews suggest that the new instruments have not yet reduced stigma associated with Fund arrangements (including by strengthening the Fund's perceived legitimacy) to a level that would make it politically acceptable to many countries to seek a financing arrangement from the Fund. A preference for self-insurance through reserves was also seen by many as a reason behind limited demand. Concerns linger over the clarity of the qualification assessment process, and a perceived excessive subjectivity in the application of the criteria. Others, especially emerging market members, see the qualification criteria as being too tough. At a more fundamental level, views differed over whether actual uptake of the new instruments is a relevant metric. Some survey respondents stressed that maximizing the number of Fund arrangements should not be seen as a goal and questioned whether a large number of FCL arrangements could have been approved without compromising the very high qualification bar.



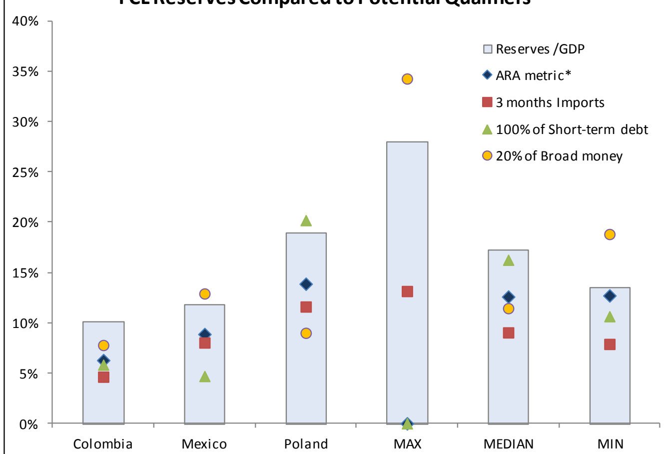

Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.
"SA" denotes Strongly agree, "DA" denotes Do not agree

## III. FCL AND PCL: CLOSE RESERVES SUBSTITUTES?

12. **In the context of the review, the question has arisen as to whether PCL and, especially, FCL arrangements are playing the role of substitute for each country insuring only by holding their own international reserves**. In discussions with interviewees, there was widespread agreement that these instruments were designed to strengthen the Fund's crisis prevention and resolution toolkit and mitigate contagion by providing primarily contingent financing against all types of BoP needs. But beyond this, some see them as providing a longstanding form of insurance—with an ongoing arrangement providing the most failsafe form of such insurance—while others view them as providing supplementary buffers principally during periods of heightened risk.

13. **One view is that FCL and PCL arrangements should be intended as a close substitute for a country's own reserves**.[11] These arrangements allow qualified members large, upfront, access to address BoP needs, with great flexibility regarding the phasing of purchases, and successor arrangements may be approved. Moreover, the extension of the duration of FCL purchase rights and the lifting of the implicit access cap for the FCL in August 2010 were seen by some policymakers as efforts to increase further the substitutability of the FCL with members' own reserves. Under this view, members' use of FCL and PCL arrangements should be quasi-permanent—ensuring the strongest form of continued insurance—to (partly) reduce demand for additional reserve holdings. An alternative way of achieving this permanent reserve-substitute status would be by allowing pre-qualification, without entering into a specific arrangement. Nonetheless, with a limited number of members using these instruments, and all of these continuing to increase reserve coverage during the period of their arrangements despite generally adequate reserve levels, there is little evidence that the establishment of the FCL and PCL have changed behavior in line with this view. Supporting this, Figure 1 shows for the FCL cases that reserves growth generally outstripped that projected out of sample by a VAR model that controls for, inter alia, the behavior of

**FCL Reserves Compared to Potential Qualifiers**




(Both reserves and the metrics of reserve adequacy displayed are the max, median and min are of 7 potential qualifiers identified by investment banks)

Source: WEO, IIP and IMF staff calculations.

* This metric was developed in the IMF policy paper *Assessing Reserve Adequacy*, (ARA) 2011

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[11] Despite potentially being a close reserve substitute, under BPM6 committed funds available under these credit line instruments are not treated as reserves, since they are not assets in a statistical sense.

commodity prices, trading partner demand and systemic AM financial stress.[12] This is also in line with survey results, where members suggest that a preference for self-insurance through reserve accumulation may have played a key role in inhibiting use of the new instruments.

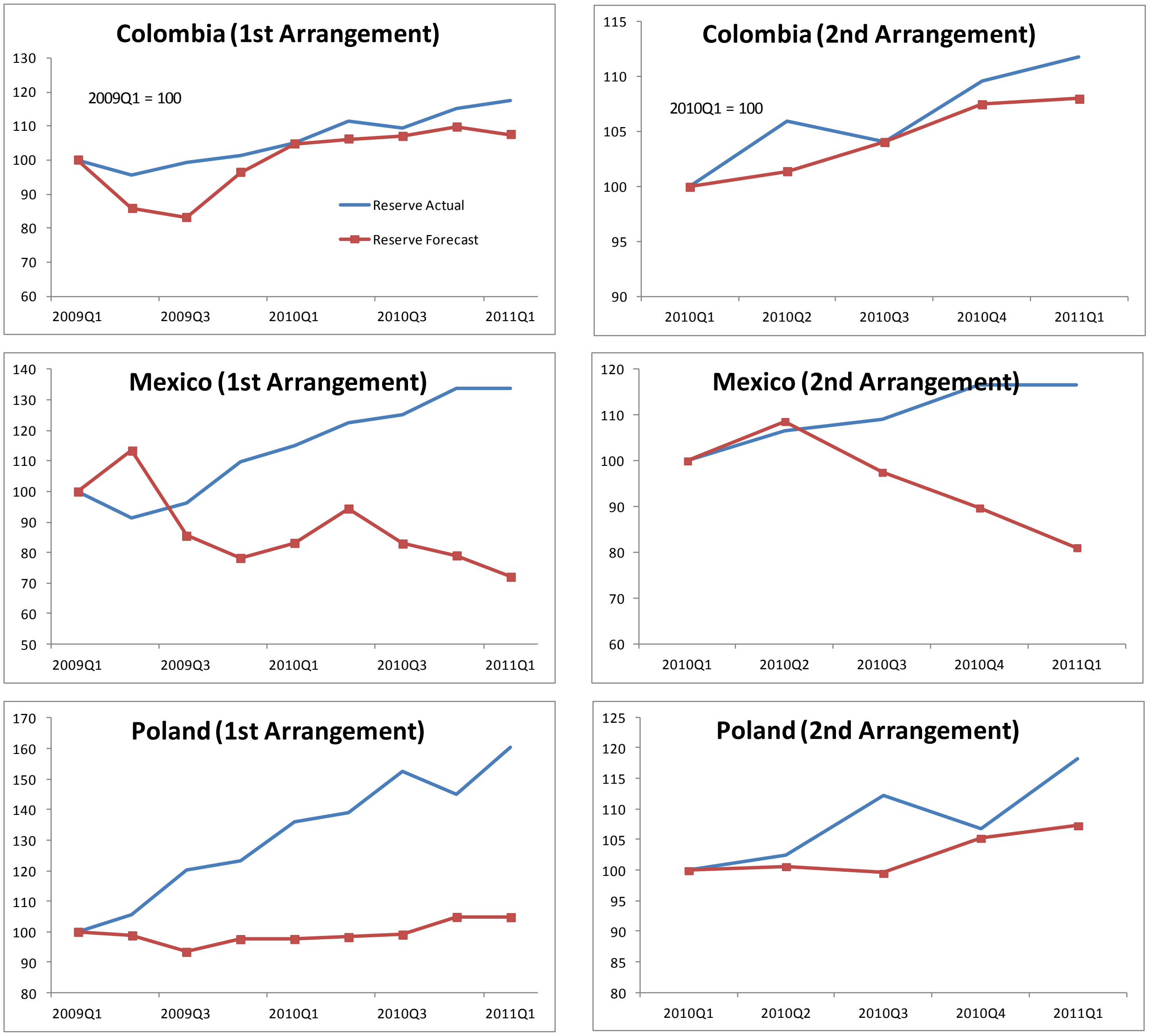
14. **A contrasting, majority view is that the FCL and PCL should mainly play the role of supplementary insurance for periods of heightened risks**. This view stresses the finite amount of available resources, and the general role of the FCL and PCL in addressing mostly exogenous risks. Under this view FCL and PCL arrangements are supplementary insurance when risks are unusually high (outside "normal" times). As such they augment the buffers a country with access to an FCL or PCL arrangement has. This view was echoed in several survey responses.

15. **The latter view is the more consistent with the overall objectives underlying these instruments**. More generally, an ex ante quasi-permanent financing paradigm would raise questions of consistency with the principle that Fund financing is to help members resolve (rather than delay the resolution of) their BoP difficulties.[13] This view does not affect the ability of the FCL and PCL to play fully their critical crisis prevention, mitigation and resolution roles during times of heightened (individual country or systemic) risks. However, as elaborated in the following section, it does mean individual members would be expected to exit from FCL/PCL arrangements once risks (and their susceptibility to these risks) have receded, with access under FCL and PCL successor arrangements also declining if the risks they face are judged to have eased, as called for by the Board with regard to the FCL in its August 2010 decision on exit (PIN/10/124).

[12] The two-lag VAR includes quarterly data on trading partner demand growth, real exchange rate changes, oil price growth, financial stress in advanced economies, domestic growth, and growth in international reserves, using data from the mid-1990s through the quarter when FCL arrangements were announced. Hence, the projections displayed are out-of-sample. There is no evidence for a structural break in any of the reserve equations based on standard statistical break tests.

[13] In the case of drawing arrangements, such ex ante quasi-permanent financing would also not be consistent with the temporary "use" of the Fund's resources.

**Figure 1. Reserves: Actual and VAR Projections at Time of First and Second FCL Arrangements (Index, 2008=100)**



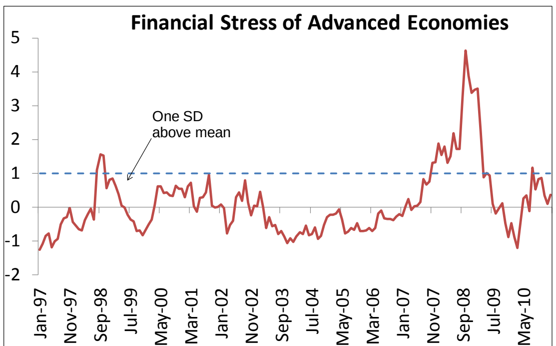

Source: Fund staff estimates.

## IV. Access and Exit

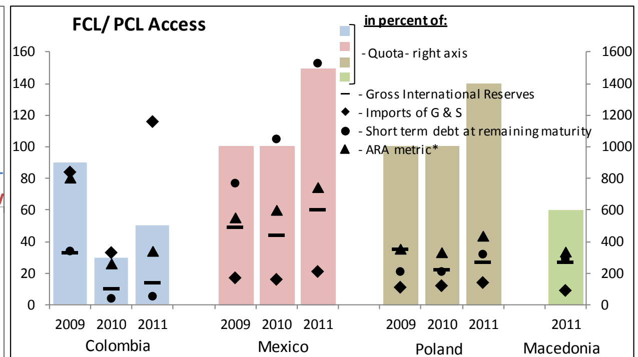
16. **As recognized by the Executive Board, access and exit are intimately linked**. In this section we consider three aspects of this relationship: (a) lessons from access decisions to date and, in particular, whether access decisions appear to have been appropriate and evenhanded; (b) whether to reconsider current access caps; and (c) exit expectations.

### A. Justification of Access in FCL-PCL Cases

17. **FCL and PCL access levels have broadly reflected potential BoP needs, which were strongly influenced by global risks**. These risks led to calculations of large potential BoP needs in recipient countries, which were in turn reflected in access levels set for each country. Exogenous financial risks (proxied by an advanced economy FSI, see chart) dipped briefly in early 2010, before reverting quickly to 2009 levels (the time of initial FCL arrangements) in the second half of 2010.[14] Partly reflecting these moves, Colombia requested reduced access in its second FCL arrangement, before requesting higher access in early 2011. Mexico and Poland, having had access under initial arrangements implicitly "capped" below desired levels, and following increased FCL flexibility, requested increased access in early 2011, also reflecting the rise in systemic risks to their respective regions through 2010.




Source: Fund staff calculations.
1/ A simple average of (normalized) monthly FSI of advanced economies. The final financial stress indicator is normalized for easy presentation.




Source: Country staff reports, Fund staff calculations.
* This metric was developed in the IMF policy paper *Assessing Reserve Adequacy* (ARA), 2011

[14] For each country, the Financial Stress Index (FSI) is constructed as an average of the following indicators: (i) three banking-related variables (the "beta" of banking sector stocks; the spread between interbank rates and the yield on treasury bills—the so-called TED spread; and the slope of the yield curve); (ii) three securities-market-related variables (corporate bond spreads, stock market returns, and time-varying stock return volatility); and (iii) one foreign exchange variable (time-varying effective exchange rate volatility). Even in early 2010, as the FSI dipped temporarily, country-specific factors added to exogenous risks, including the Eurozone periphery crisis (affecting Poland) and the expiry of the Federal Reserve swap lines (affecting Mexico).

18. **As in any other type of Fund financing, access under FCL and PCL arrangements is meant to be based on plausible adverse scenarios**.[15] The FCL guidance note provides a detailed description of considerations that should inform such scenarios, including global risks, past crises, country-specific factors, and "additional considerations" or "cushions" (defined in the guidance note as "further potential downside risks on the BoP beyond those considered under the adverse scenario").[16] [17]

19. **Some common themes have emerged from adverse scenarios considered in past and current FCL-PCL cases**. Across FCL and PCL arrangements both current account and capital shocks have played a role (see table below and case studies). Shocks to the trade balance (including commodity prices), as well as lower FDI and liability rollover rates have been a common feature across arrangements. During interviews, some staff noted that it was more difficult to calibrate capital than current account shocks, but that the former were more important (Colombia being the exception).

20. **Assumptions underpinning shock scenarios differed markedly across country cases, however, without full explanations in staff reports, complicating access comparisons**. The crisis prevention role of these instruments (and standard Fund policy calling for assessments of potential BoP need in the calculation of access levels) allows high upfront access. As with other types of precautionary arrangements, however, access should be tied to well-articulated plausible downside scenarios.[18] Although improving with experience, the description of underlining scenarios in some staff reports was relatively limited and based mainly on country-specific experience that were not explained in detail. Beyond the scenarios, assumed reserve and access "cushions" have also varied across FCL cases (see case studies), again without full explanations, with the cushion as large as a quarter of access in some cases (see Figure 2).

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[15] The attachment to *The Flexible Credit Line—Guidance on Operational Issues—Determining Access on a Precautionary Basis*—states "When access is requested on a precautionary basis, staff should construct a plausible adverse scenario to help determine an estimated potential financing gap and the appropriate level of access."

[16] *The Flexible Credit Line—Guidance on Operational Issue, Attachment I*.

[17] Annex I of *GRA Lending Toolkit and Conditionality—Reform Proposals*, as well as the attachment to *The Flexible Credit Line—Guidance on Operational Issues—Determining Access on a Precautionary Basis*—have an extensive discussion of access considerations.

[18] *Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options*.

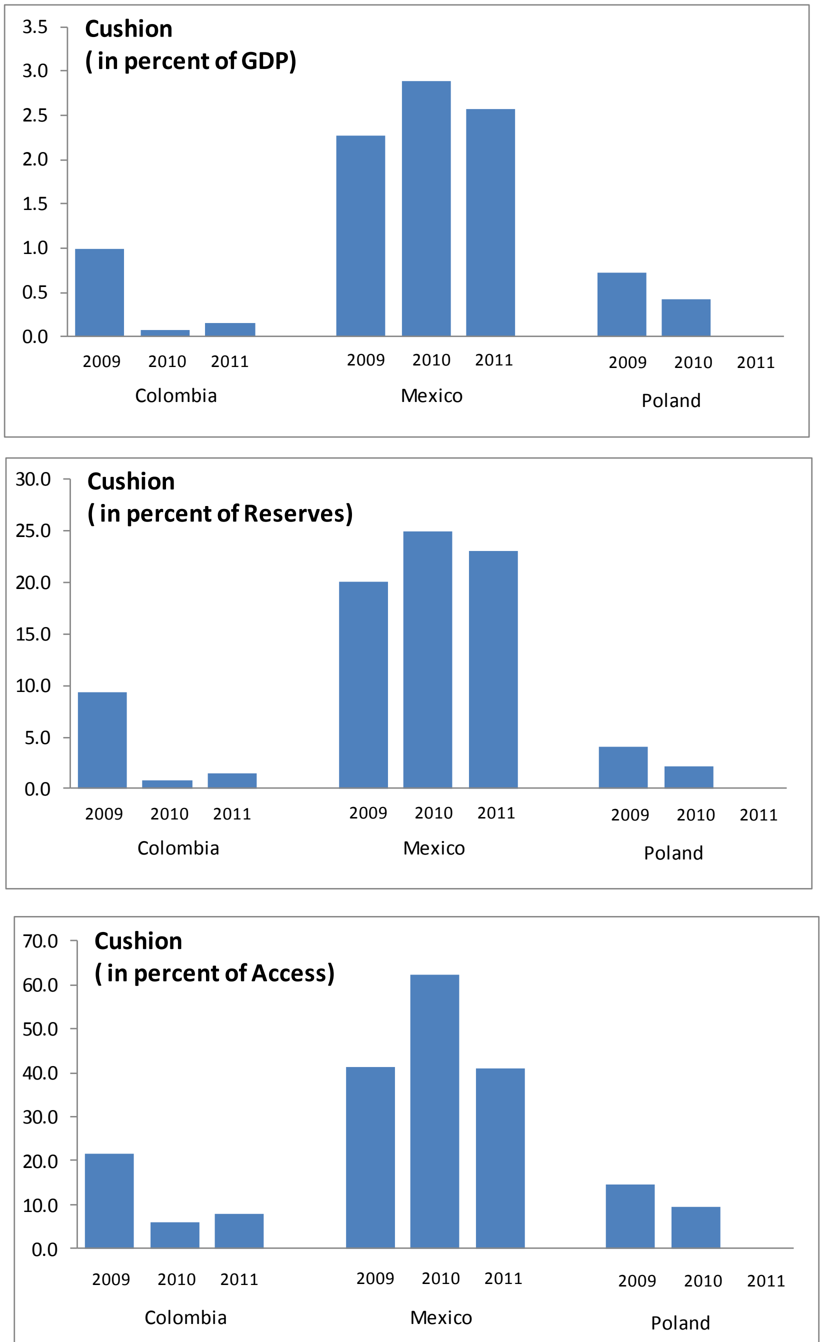
**Table. Assumptions Underpinning Adverse Shock Scenarios**

| Shock | Colombia | FYR Macedonia | Mexico | Poland |
|---|---|---|---|---|
| FDI | ✓✓✓[1/] | ✓ | ✓✓ | ✓✓✓ |
| Portfolio Investment outflows | X[2/] | X | ✓✓ | ✓✓✓ |
| Other Investment outflow | X | ✓ | ✓✓ | ✓✓✓ |
| Drawdown of Foreign Asset (inflows) | X | X | X | ✓ |
| Exports | X | ✓ | ✓ | X |
| Non-fuel commodity prices | ✓✓✓ | X | X | X |
| Fuel price | ✓✓✓ | X | X | X |
| Other current account shocks (e.g., remittances, transfers) | ✓ | X | ✓✓ | X |
| Public ST rollover | ✓✓✓ | ✓✓✓ | ✓✓✓ | ✓✓✓ |
| Private ST rollover | ✓✓✓ | ✓✓✓ | ✓✓✓ | ✓✓✓ |
| Private MLT rollover | ✓✓✓ | ✓✓✓ | ✓✓✓ | ✓✓✓ |

Source: Various IMF Staff Reports

1/ The number of ✓ indicates the overall frequency in one country's FCL/PCL arrangement scenarios.
2/ X marks that the item never appears in one country's FCL/PCL arrangement scenarios.

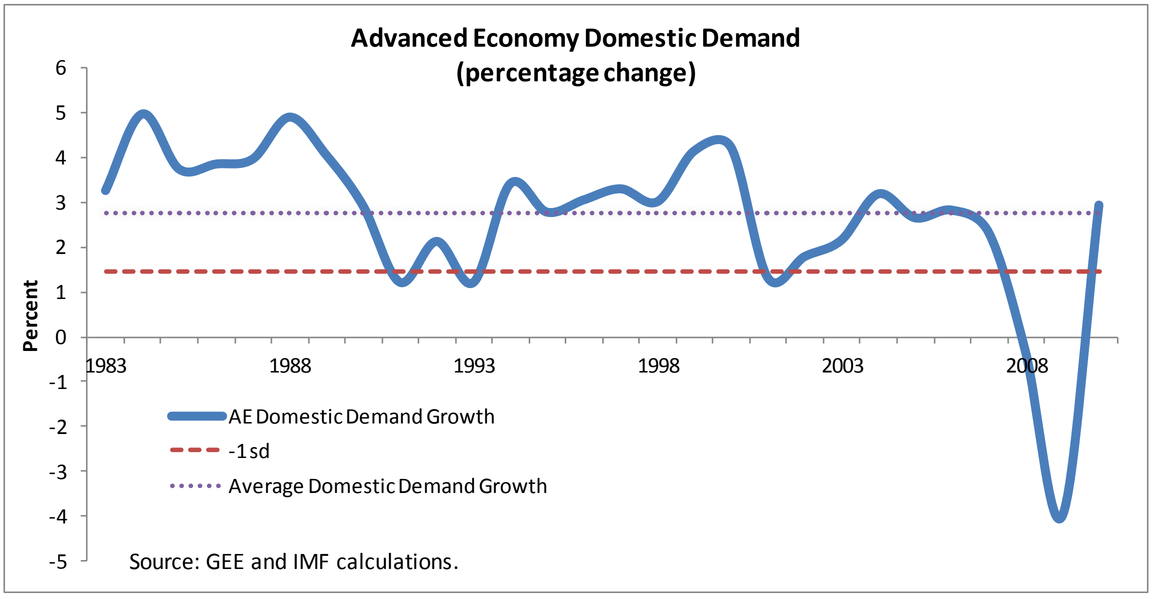
**Figure 2. Assumed Access "Cushions" in FCL Arrangements**




Source: Fund staff calculations.

21. **To compare the implicit assumptions on tail risks across current and past cases, the review compares key access components**. To do this, we place the implicit assumptions from FCL-PCL cases in empirical distributions of key EM access parameters (see Figure 3). The empirical distributions are estimated using data for all EMs and are conditioned, importantly given the strength of FCL and PCL cases, on events exogenous to their domestic

situations.[19] Specifically they are based on episodes of (exogenous) advanced economy domestic demand compression in the past 30 years (similar to the financial stress index).[20]




22. **Using this framework, it can be seen that the severity of assumed shocks fell under the second FCL arrangements, before increasing as global conditions worsened** (see Box 4 and Figure 3). Another interesting finding is varying degrees of severity of various shocks across BoP category. For instance, in Colombia's first FCL arrangement, the assumed rollover rate for private short-term debt is considerably further into the tail than that assumed for MLT private debt. Use of a unified framework, like the one used here, to underpin future access discussions would both help to better align the assumptions across categories, as well as better draw out the reasons for such differing assumptions by making clear the severity of shocks assumed in each case.

[19] The distributions for commodity prices are, by contrast, the unconditional distributions of commodity price changes.

[20] The data covers the 1980–2008 period, and identifies demand declines by more than one standard deviation relative to its long-run mean (over this period), i.e., 1991, 2001 and 2009. As explained in Box 4, the distributions for exports and FDI are estimated over the ratio between the variable and its average over the preceding three years. The shocks assumed in the program documents are adjusted (using the assumed baseline in the relevant document) to be in relation to three-year average preceding their assumed impact to make them consistent with the distribution.

## Box 4. A Possible Framework for Comparing Access Assumptions

**This box outlines a possible framework for comparing access assumptions across members availing themselves of the FCL or PCL**. This involves, first, identifying past events where EMs have been hit by large exogenous (AM-led) shocks. The second step involves gathering information across EMs on key access determinants—both on the current and financial account—so that access assumptions can be compared with past behavior of key variables during shock episodes

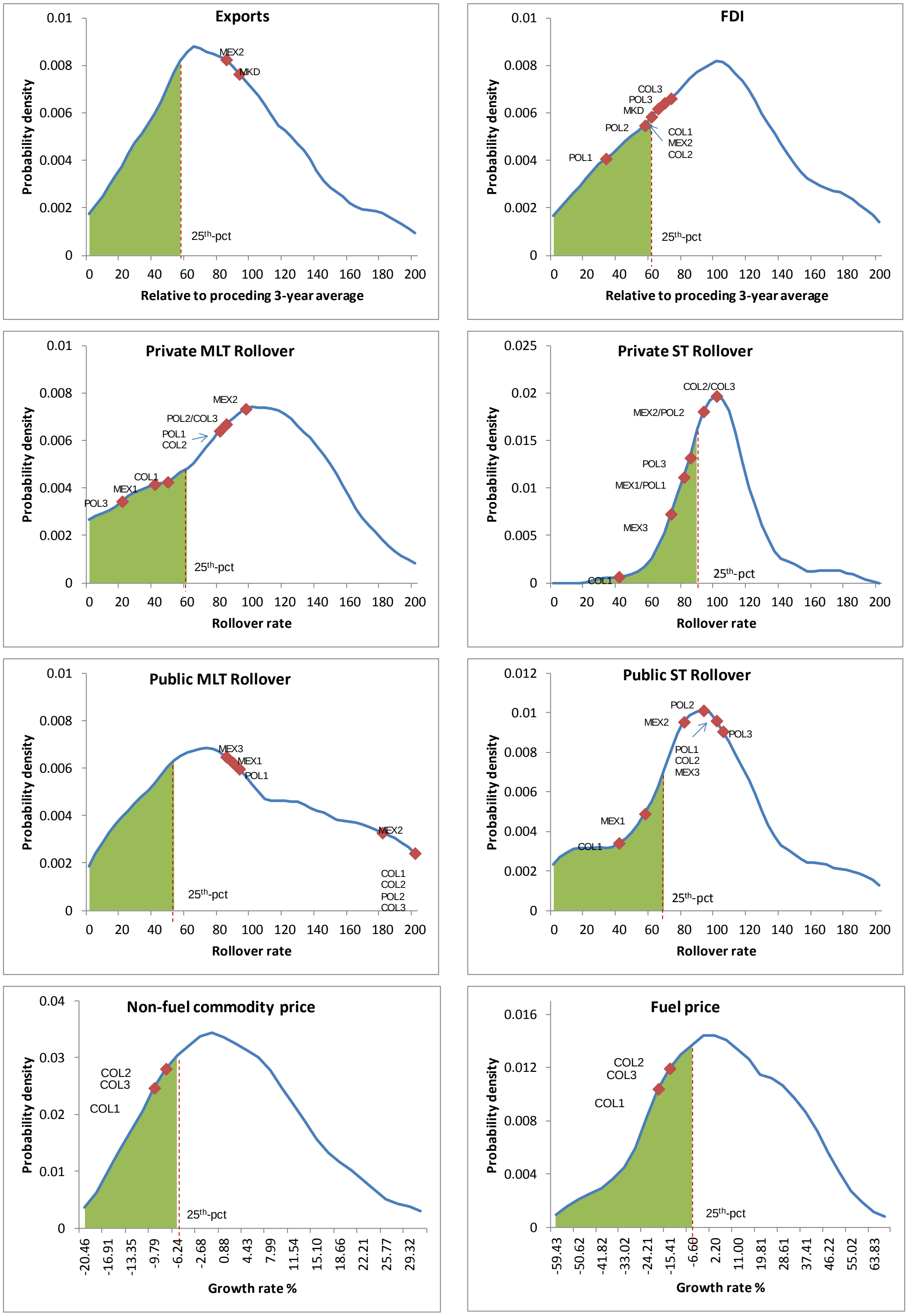
**The first step involves identifying exogenous shock periods**. Specifically, this involves identifying the impact on EMs stemming from a decline in domestic demand and elevated financial stress in their AM trading partners. Over the past 30 years, annual AM real domestic demand compression bridged the one standard deviation threshold in the years 1991, 2001, and 2009. Excessive advanced economy financial stress also coincided with these events. These periods were followed by economic stresses across a number of EMs and are, as such, categorized as crisis events.

**The second step involves measuring moves in key external variables across EMs during these identified crisis periods**.

- **Country sample**. 49 EMs are selected that are medium sized, have market access and attract private inflows through FDI, portfolio flows and loans. This broadly coincides with the sample of countries chosen for the Fund's Vulnerability Exercise for Emerging Markets (VEE).
- **Variables**. Eight separate external variables are used in the analysis, focusing on those variables in the current and financial accounts that form the basis of downside risk assumptions in past FCL access decisions. These variables comprise exports, FDI, commodity prices excluding fuel, fuel prices, and short- and MLT public and private rollover rates. (Other variables could also be added over time if needed, e.g., deposit outflows.)
- **Density distributions**. This step involves identifying density distributions for the behavior of external variables during past exogenous stress episodes for EMs. For each variable, values for countries *i : 1, …, I* in the event years are stacked in a vector denoted with *x*. These vectors are used to estimate univariate kernel densities. Kernel density estimators approximate the density *f(x)* from observations on *x*. The data are divided into non-overlapping intervals, and counts are made of the number of data points within each interval so that FCL arrangement assumptions can be presented on these distributions with greater precision. Kernel distributions provide comparable benchmarks to calibrate the assumptions used in past FCLs for key external variables, which in turn helped determine access levels.
- **Time period**. For FDI and exports, averages spanning the three years prior to the crisis year are used as a baseline. The crisis year deviations from these baselines are then used as *the shock s*cenario. For private and public rollover rates, episode year values are used to estimate densities. Finally, for commodity and fuel prices time series values for the 1991–2011 period are pooled to estimate the densities. FCL and PCL cases are placed on these densities based on the shock scenarios that are described in country case studies (see attachment).

**The past experience of EMs during such episodes may be summarized as follows**: Relative to pre-event trends on average, EMs observed a 15 percent decline in exports, a 5 percent decline in FDI, and a 5−10 percent decline in rollover rates (larger declines for longer maturities).

## Figure 3. Empirical Adverse Shock Distribution[1/]




Source: WEO, IFS and Fund staff estimates.
1/ Rollover rates are computed as the amount of new borrowing in year *t* divided by the amortization falling due in that year.

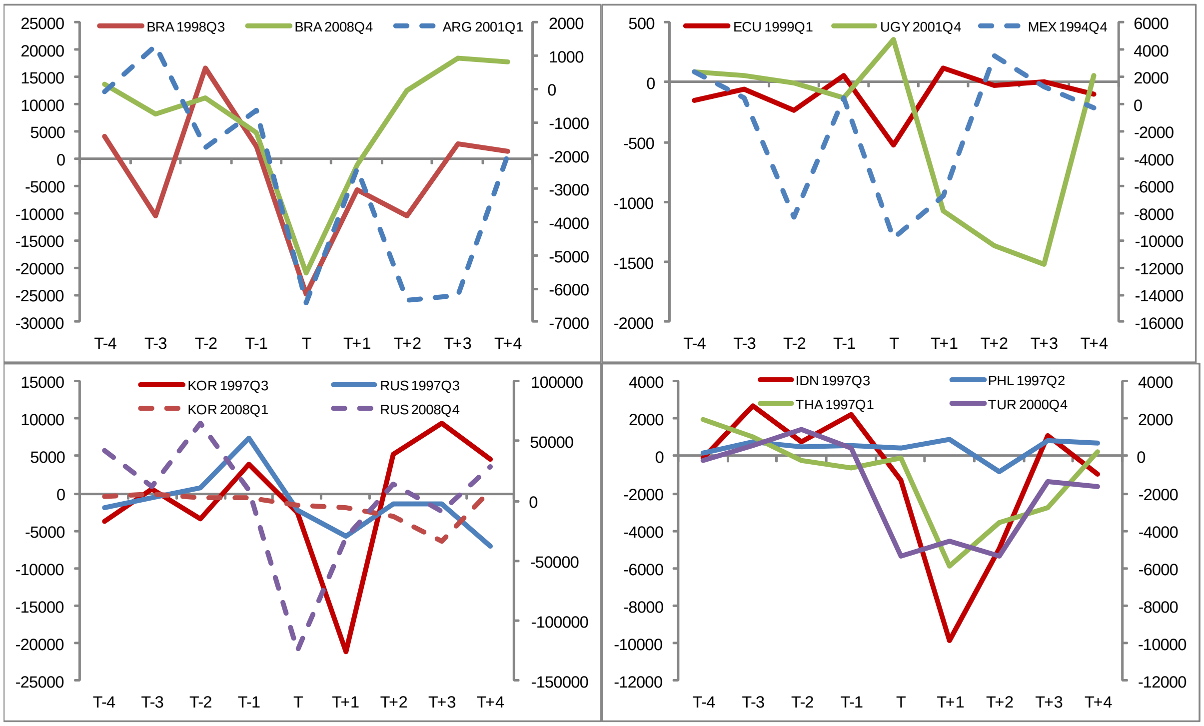
23. **Assumed reserve use under adverse scenarios also differed across arrangements**. Under Colombia's recent FCL arrangements, it was assumed that reserves accumulated in the baseline were fully used under the adverse scenario. This was not the case in Mexico, with the assumption in the Poland arrangements in the middle. The FYR Macedonia request anchored minimum reserves level to a metric of reserve adequacy. While insurance may be used to limit reserve losses under an adverse scenario, reserves are there to be used during crisis conditions.[21] In fact, in all but a very small minority of other GRA financing cases, countries use at least part of their own reserves in filling financing gaps before or during their program. As a result, it would be more appropriate, even in the unusual case where reserve levels need to rise over the arrangement, to anchor minimum reserve adequacy under the adverse scenario to some kind of well-established "lower bound" (e.g., 80 percent of the *Assessing Reserve Adequacy* metric or some other country-appropriate and widely-used reserve metric), with any additional reserves generally to be used under an adverse scenario. Allowance could be made for deviating from this approach in cases where, for example, fear of reserve loss is justified by the structure of members' balance sheets.

24. **Program duration and access need to be disentangled**. Even during severe crises, reserve pressure typically lasts just a few quarters, suggesting a year is about the correct interval for adverse scenarios that determine BoP need and thus, the corresponding level of access. For the 11 most severe crisis events described in the initial *Review of Recent Crisis Programs* paper, as well as three extreme events from the current crisis, reserves (excluding IMF disbursements) stopped falling *within 4 quarters* (Figure 4), indicating that the worst of the crisis, in terms of BOP pressure, was over. As such, basing BoP needs and thus the corresponding access level on reserve losses over a rolling 12-month window seems appropriate, even for longer-duration arrangements. Such an approach would treat the duration of arrangements and access determinations as largely separate issues, with access addressing insurance needs and duration dealing with the period over which this insurance is available. Accordingly, the recent extension of the duration of FCL purchase rights from six to twelve months, with a maximum arrangement length of two years, does not mean that access decisions under such arrangements—which are based on an assessment of BoP needs—should be expected to expand only for this reason.[22]

[21]The FCL Guidance Note indicates that only "where it is clear that reserve level need to rise over the course of the FCL to maintain reserve adequacy" would staff want to maintain baseline reserve accumulation under the adverse scenario.

[22] *The Fund's Mandate—The Future Financing Role—Reform Proposals*.

**Figure 4. Changes in Reserves (excluding use of IMF credit and loans)**
(In millions of U.S. dollars)




Sources: IFS and IMF staff estimates

25. **These findings suggest that a more transparent approach for determining access levels is needed**. Each country team should continue to build scenarios based on the types of current and capital account shocks they see as particularly relevant for their country. They would also be responsible for specifying the severity of the shock insured against, with each staff report expected to clearly justify this based on the near-term risks facing the country. There would be no presumption against different countries requesting different levels of insurance (insuring against differing severity of shocks), or country teams taking somewhat differing approaches in justifying the severity of shocks assumed. The objective is simply to make the case for access presented in requesting reports more transparent. The desirability of a more systematic approach to support the determination of access levels was seen by the senior staff interviewed for this paper. More specifically, the review recommends that the following steps (which do not require any changes in the FCL or PCL decisions) be followed in future cases:

- ***Directly* link proposed access with the actual or potential BoP needs in the staff's written analysis, carefully justifying any use of "cushions**." The assessment of BoP needs should be linked to a plausible and relevant adverse scenario that is global to the extent possible and also reflects country-specific circumstances that should be explained clearly in the relevant papers. Additional access cushions—beyond those considered under the adverse scenario—should be carefully justified in all cases.

(These could sometimes even be negative given the catalytic nature of Fund financing, as is common for other precautionary arrangements.)

- **Link adverse shocks to tail risks**. Shocks could, for transparency and comparability purposes, be chosen from a common distribution of relevant externally-driven "crisis" events, as described above. An amended guidance note (and database) could help provide distributions for assumed shocks. Staff would then be expected to discuss the severity of adverse scenario shock assumptions in this context. A similar approach, albeit with a different distribution given that domestic factors would be expected to play more of a role (due to their weaker fundamentals and policy frameworks), could be considered for the access discussions of SBAs which authorities express an intention to treat as precautionary. Non-standard considerations, such as the expiration of a credit- or swap-line, could also be added to the access justification.

- **Make use of reserves metrics**. Adverse scenarios should gauge minimum reserve levels under the adverse scenario on relevant metrics (e.g., 80 percent of the Assessing Reserve Adequacy metric or other justified reserves metric). This would be more consistent with the approach taken in other program cases.

- **Delete market-sensitive access discussion, as warranted**. Under the Fund's transparency policy market-sensitive information on access determination can be deleted from staff reports, where warranted by circumstances.

### B. Access Limits and Caps: Differences between PCL and FCL

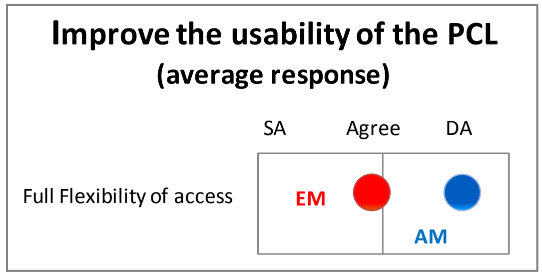
26. **Experience to date does not suggest any need to change the current access rules**. Reflecting the FCL's rigorous qualification criteria, the implicit access cap for FCL arrangements was removed in 2010 to enhance flexibility and avoid creating an expectation that this was a norm rather than a ceiling. At the same time, a hard access cap applies to PCL arrangements as an additional safeguard for Fund resources in light of the moderate remaining vulnerabilities of PCL qualifiers.[23]

- ***For the FCL***, the removal of access caps provided greater assurance to members that they had access to adequate resources, increasing the attractiveness of the instrument. Assuming sufficient Fund resources, the absence of an access cap, especially during systemic events, should help boost market confidence and underpin the Fund's financing role. Also, reversing course by re-introducing FCL access caps so quickly could be problematic.

- ***For the PCL***, the access limit and cap provide safeguards to Fund resources for members whose track record is not as strong as FCL qualifiers. This safeguard is particularly important given proposals to allow the approval of PCL arrangements where the member has a present BoP need at the time of approval, and to address short-term needs through shorter duration arrangements (which would raise

[23] *The Fund's Mandate—The Future Financing Role—Reform Proposals*.

heightened risks if the member's need were to turn out to be less short-term than initially envisaged). And, in practical terms, the 1,000 percent of quota cumulative access cap remains high, providing sufficient scope for the financing likely to be needed by qualifying members: aside from the FCL arrangements of Mexico and Poland, since 2000 there have been no precautionary arrangements with access exceeding 1,000 percent of quota, and only 7 percent of all SBA arrangements (less than a third of total access) have had access above this level.[24] Beyond this, hard access caps also benefit the members by encouraging prompt policy adjustment and early access to private markets, which would send positive signals and help boost market confidence in the country. Survey views on the deterrent effect of the hard access cap for the PCL differed between advanced and emerging markets, with the former seeing it as largely irrelevant and the latter (along with private market respondents) as a more of a factor limiting demand.




Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.
"SA" denotes Strongly agree, "DA" denotes Do not agree

## C. Exit and Expectation of Declining Access

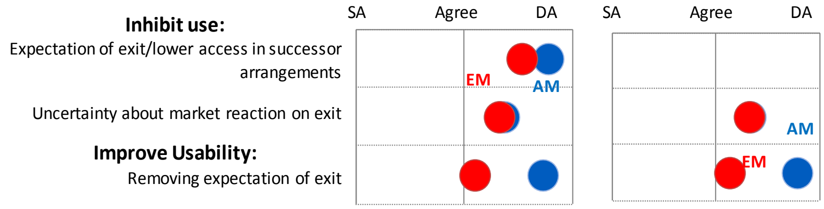
27. **As already noted, some Executive Directors have, on various occasions, raised concerns about the lack of an exit strategy from current and past FCL arrangements**. This has not yet been flagged as an issue for the PCL, but this likely reflects that no member has requested a successor PCL arrangement. Directors have favored well-communicated exit strategies from FCL arrangements, with some Directors calling for articulated exit plans upon approval. While there was a brief discussion of exit plans at the time of the review of the first three FCL arrangements, the issue of exit came to the fore during discussion on the approval of the current FCL arrangements, when durations were lengthened and access levels were increased.

28. **Exit in cases with successor arrangements is expected to involve declining access if warranted by improvements in external financing prospects**. In the summing up to *The Fund's Mandate—The Future Financing Role—Reform Proposals*, Directors agreed, in addition to other relevant factors justifying lower access, that access under the FCL "would normally be expected to decline in successor arrangements whenever improvements in official and private financing prospects have reduced the member's potential or actual balance of payments needs in a sustained manner" (PIN/10/124). This expectation is an element of the FCL policy established in the 2010 summing up and it sets the minimum parameters for exit discussions. That said, it clearly limits the expectation of declining access to episodes of declining country risk (improving financing prospects), as forcing poorly

[24] In the event that a member has a present need at the time of approval of the arrangement in excess of these limits, alternative financing instruments exist, including the SBA.

timed exit could hurt the exiting country and others.[25] Nonetheless, country authority responses to the survey also suggest that changes in exit expectation would not dramatically improve the usability of the FCL and PCL.

**Exit and the usability of FCL (left) and PCL (right)**
**(average response)**




Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.
SA" denotes Strongly agree, "DA" denotes Do not agree

29. **Despite this expectation, protracted stress in global financing conditions has likely hampered declines in access**. Access in successor FCL arrangements declined only in the case of Colombia's second arrangement. Aggregate global economic risks have remained elevated since the creation of the FCL in 2009 and have not resulted in financing improvements for FCL users that would reduce their potential BoP needs on a sustained basis. Focusing on each case in turn, Directors welcomed ***Colombia's*** lower access on the second FCL arrangement as an appropriate and well-calibrated sign of exit, although authorities stressed the perceived decline in risks may not be sustained. The increase in access in the third arrangement confirmed the authorities' earlier assessment, with the higher access resulting from the fact that shocks similar to those in the second arrangement would result in a larger impact given the improved baseline (see case studies). ***Poland*** did not have an arrangement for a few months after its first FCL arrangement, although market participants expected Poland to request a successor arrangement given heightened global risks. Directors questioned increased access levels under its current arrangement and the absence of an exit strategy implied by the higher level of access. The same holds for the current ***Mexico*** arrangement although as elaborated in the discussion on access below as well as in the accompanying case studies, Mexico and Poland considered access at the implicit 1,000 percent of quota cap in place during their first two arrangements as underinsurance given the extent of systemic risks.

30. **Decisions regarding exit should fundamentally depend on external risks**. Promoting further discussion and transparency about exit prospects at the outset (possibly coupled with reforms to the commitment fee schedule) could underpin current exit expectations. While global conditions, and the associated uncertainties over members' BoP needs, have precluded exit to date, expectations related to exiting from FCL arrangements would need to be carefully managed to avoid sending adverse signals to markets. To this end, and to avoid excessively conservative assessments about readiness to exit FCL arrangements:

[25] Further, the fact that this is a "normal" expectation rather than a mandatory rule means that the Board could, where justified by exceptional circumstances, approve access that is not declining even if there are improving financing prospects as contemplated in the summing up.

(i) members could add exit expectations in their written communications requesting FCL arrangements; and (ii) staff could discuss, to the extent possible, the anticipated evolution of risks over the subsequent year or two (based on the recent WEO or GFSR) at the time of each request or review. This information could then be used to inform the discussion of access, in terms of the evolution of risks, if a successor arrangement is ultimately considered. While such moves would bring with them the advantages noted above, they need to be carefully balanced with the need to not undermine the attractiveness of the FCL instrument and its public good nature, as well as raise the risk of an adverse market reaction if a country that is expected to exit decides not to. The possible role for commitment fees to shape access incentives and discourage large precautionary arrangements is discussed in section V.

## V. Review of the Design of the FCL and PCL

### A. Qualification

31. **A critical aspect of both the FCL and PCL is the application of rigorous qualification criteria** (see Box 5). For the FCL, qualification involves a judgment based on: whether a member has very strong economic fundamentals and institutional policy frameworks (based in part on a very positive assessment of the member's policies in the most recent Article IV consultation assessments); is implementing—and has a sustained track record of implementing—very strong policies; and remains committed to maintaining such policies in the future. For the PCL, qualification is based on similar metrics, although the bar is set lower (e.g., sound policies, generally positive Article IV assessment, track record of implementing sound policies). Reflecting this lower qualification bar, the lack of an actual BoP need at the time of approval was also set as a PCL qualification criterion, and members facing major capital market pressures, with large adjustment needs, unsustainable public debt, or widespread bank insolvencies were also disqualified from the PCL. Ultimately, however, there are no "bright line" numerical qualification criteria for either of these instruments, and the qualification frameworks contain nuanced and judgmental elements, including in the quantitative assessment.[26] Since subjectivity is inescapable, the discussion in the qualification assessments needs to provide a suitable basis for ensuring transparency to alleviate the concerns to the extent possible.

32. **The qualification assessments in each of the four FCL and PCL cases appear broadly appropriate**. Each of these countries had established appropriately very strong or sound policies and institutions (for the type of instrument they received access to). That said, qualification assessments have largely relied on quantitative factors for the specific country at hand in isolation and typically without explicit comparison with peers. As such, even for the existing cases of countries with FCL arrangements, the qualification assessment process could, in addition to their emphasis on quantitative indicators (as described in the case studies), usefully have placed a stronger focus on qualitative elements that are also required under the framework, including institutional strength and forward-looking policy commitment (see below).

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[26] Examples include "sustainable" external position, reserve position that is "relatively comfortable", "sound" public finances, and "sustainable" public debt.

33. **Qualification judgments reached for other members whose interest in an FCL or PCL arrangement was never submitted to the Board are more difficult to assess**. The initial stages of the qualification process are to be strictly confidential, to ensure that the member is protected against the potentially negative impact if their interest were leaked. It is understood that some members inquired into the possibility of availing themselves of the instruments and were informed of staff's preliminary assessment that they did not appear to qualify or that further steps would be needed in order to pave the way for qualification. This practice also occurs under other types of arrangements, and none of the members have had their possible interest leaked. Moreover, these assessments seem to have been based not only on a comparison of performance across quantitative indicators, but also on members' track records and prospects. In no case did a member challenge the decisions through the Executive Board—e.g., by requesting that its interest in an FCL or PCL arrangement be put before the Board without management's recommendation—although in a limited number of cases, members disagreed with the assessment by senior staff and management. Overall this experience suggests that the procedures appear to have worked relatively well. It also suggests that there may be merit in maintaining strict confidentiality, and informing the Board of interest in Fund financing only after management has reached a judgment that access may be appropriate, as required under the terms of the FCL decision.[27] It should be noted that taking a different approach—say by using pre-qualification for these instruments—would come with many drawbacks as has been noted in previous discussions, including moving the Fund further down the "rating agency" route, thereby undermining its trusted confidential advisor role. This is, however, an area of contention and one that could be revisited as further experience is gained with these instruments.

34. **Nonetheless, the survey results and interviews of senior staff identified areas for improvement in the qualification assessment process**. Given the critical role ex ante qualification plays in both these instruments, it is perhaps natural that views differed on how to proceed. While the majority of emerging markets viewed overly strict, unclear and subjective criteria as key factors inhibiting FCL use, advanced countries, market participants and some large emerging markets argued strongly for keeping the FCL qualification bar very high for signaling purposes and to prevent moral hazard concerns. For the PCL, private sector respondents noted the lack of clarity over potential qualifiers compared to the FCL. Concern was also expressed in the interviews regarding the high weight placed on backward-looking quantitative indicators relative to more qualitative and forward-looking elements. Given the nature of the instruments, which are designed for members that have sufficiently strong institutions to cope with shocks requiring policy adjustment, it is critical and inherently required under the qualification standards of both the FCL and PCL to place high weight on both backward- and forward-looking components of institutional and policy strengths. Consequently, respondents saw that some refinement of the emphasis of the qualification discussion was considered helpful. Both are discussed in detail below. In doing so, it will be important to balance the greater emphasis on qualitative criteria with the need for transparency, and relative predictability.

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[27] Paragraph 6(a)(i)-(iii) of Decision No. 14283-(09/29), adopted March 24, 2009, as amended.

## Box 5. FCL and PCL Qualification

**FCL and PCL qualification is based on very strong (FCL) and sound (PCL) performance in economic fundamentals, institutional policy frameworks, and policy implementation**. A member's qualification for an FCL arrangement is assessed against nine criteria specified in the FCL decision.[1/] Qualification for a PCL arrangement is assessed in five broad areas: (i) external position and market access; (ii) fiscal policy; (iii) monetary policy; (iv) financial sector soundness and supervision; and (v) data adequacy. The nine FCL qualification criteria are encompassed by the five PCL qualification areas. [2/]

**The FCL/PCL qualification framework comprises both backward-looking quantitative indicators and criteria of a more qualitative nature** that attempt to capture salient features of the macroeconomic policy frameworks in place. The qualification bar for the FCL is very high : in Annex I of the GRA toolkit, while it is noted that strong performance against all relevant criteria is not necessary to secure FCL qualification, any significant shortcomings on one or more of these criteria (unless there are compensating factors) could generally signal that a country is not among the set of strong performers for whom the FCL is intended. PCL qualification requires strong performance in most (i.e. 3 out of 5) of the relevant areas, but without substantial underperformance in any of them. Given the lower PCL qualification requirements, assistance under the PCL is provided not only on the basis of ex ante conditionality (qualification) - as is the case of the FCL - but also with reliance on streamlined ex post conditionality aimed at addressing remaining moderate vulnerabilities of PCL qualifying countries.

**The quantitative and qualitative factors summarized in the FCL Guidance Note play distinct and complementary roles in the assessment of FCL qualification**. The choice of backward-looking quantitative indicators is motivated by the results of the Vulnerability Exercise and the crisis literature. They include variables that have proved significant predictors of currency/banking/sovereign crises. While use of as broad a set of such indicators would in principle be desirable, in practice data limitations and issues of definition consistency tend to constitute important constraints for cross-country assessments; accordingly, only a subset of the full range of indicators (budget deficit and public debt; inflation; current account balance and external debt) has tended to be used for FCL/PCL qualification assessments. On the other hand, the qualitative criteria considered are designed to capture the robustness of the macroeconomic policy frameworks in place. This more forward-looking assessment is essential under FCL and PCL arrangements to provide assurances that policies would adjust appropriately to (current or potential) shocks, since there is limited or no ex post conditionality and phasing to facilitate and monitor adjustment. However, it has been underemphasized in the qualification for past and existing arrangements (see Annex I for details).

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1/ See paragraph 2 of the decision establishing the FCL, Decision No. 14289-(09/20), adopted 3/24/09, as amended.

2/ The qualification table attached to *The Fund's Mandate—The Future Financing Role: Revised Reform Proposals* specifies the mapping of the FCL qualification criteria into the five broad areas.

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### Quantitative Assessments

35. **While quantitative qualification indicators provide a key input to qualification, there is also a need for comprehensive qualitative assessments**. Even within the set of very strong performers, the set of countries that performs exceptionally well across multiple areas is very small and evolves over time. To get a sense of this, we look at emerging markets that have relatively low vulnerabilities in the Vulnerability Exercise for Emerging Markets (VEE)—based on empirical thresholds chosen to indicate crisis risk—in the external, fiscal and financial sectors. The results, which are captured in the form of Venn diagrams, which date from around the time of the approval of the first round of FCL arrangements, suggest that FCL qualifiers are generally within the group of strongest performers (see Figure 6). Nonetheless, the set of countries that is "super strong" (those in the center of the Venn diagram) is very small and changes over VEE vintages.

36. **There may be merit in more direct use of assessments from VEE/VEA/VE-LIC-based analysis in FCL-PCL qualification assessments, as one ingredient in the overall**

**assessment**.[28] To this end, it helps that a number of the quantitative indicators under the five broad areas for the assessment are also the basis for the quantitative VEE indicator assessment in each corresponding area (see Figure 5). If deemed desirable, the use of the VEE in qualification could be achieved by reference to the country-specific public, external, and financial sector indicator ratings from the most recent VEE round in any new request.[29] Even if used the VEE ratings should not be determinative, but their greater use would take account of their additional consistency and rigor over the current list of indicators, since the VEE/VEA/VE-LIC assessment is based on empirical thresholds associated with underlying vulnerabilities.

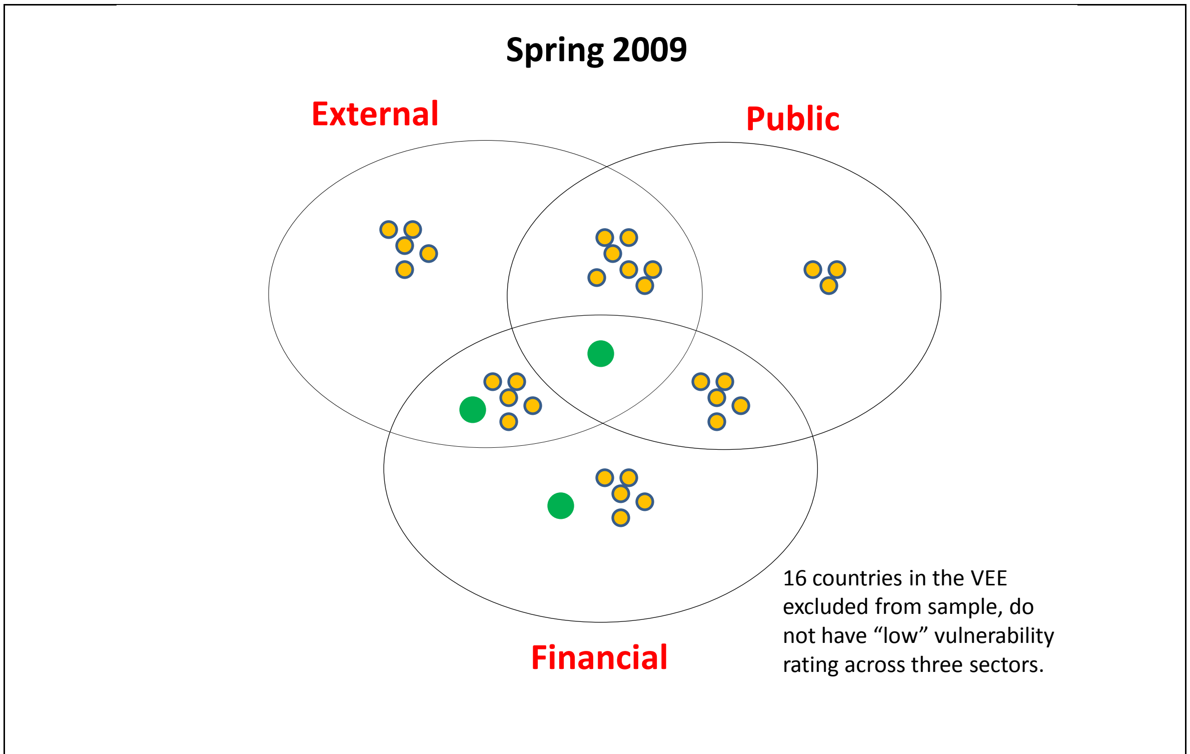
**Figure 5. Comparison of Some FCL and VEE Assessment Factors**

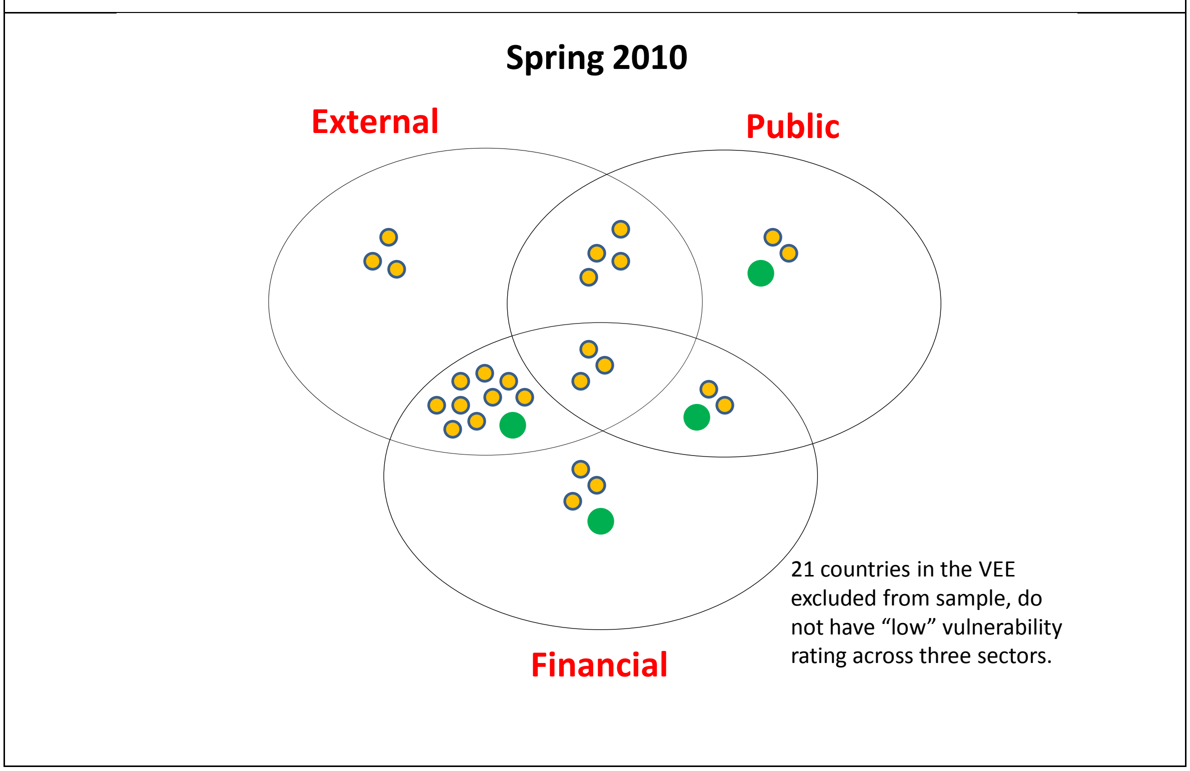
| FCL Qualification | VEE |
|---|---|
| ***External Position and Market Access*** | ***External Sector*** |
| Ratio of reserves to: short-term debt (remaining maturity basis); Short-term debt (remaining maturity basis) plus current account deficit; imports; and broad money, Short-term gross external debt/GDP | Reserve coverage GIR/(ST ED+CA) |
| Debt-stabilizing Noninterest current account deficit; DSA Assessment | Current Account (% of GDP) |
| Gross/Net external debt/GDP | External Debt (% of Exports) |
| | REER overvaluation |
| Share of bank, nonbank and public sector gross external debt | Private sector external debt (%) |
| FDI plus portfolio inflows as a share of total inflows; ratio of private holdings of external debt to gross external debt; and private foreign holdings of domestic debt/total domestic debt | |
| EMBI spread; spread between country EMBI and EMBI overall index (using latest observation and averages over previous five years); Current yield on benchmark bonds; credit ratings; and last external issuance (details on amount issued/ original yield/maturity) | Countries in the VEE sample had/have market access. |
| ***Fiscal Policy*** | ***Public Sector*** |
| Primary and overall fiscal balance (average for the last 3/5 years) | Fiscal balance (% of GDP) |
| Debt sustainability assessment, Structural fiscal balances and debt-stabilizing primary balance | Primary Gap (% of GDP) |
| Public sector debt | Public debt exposed to rollover risk (% of GDP) |
| | Public Debt (% of GDP) |
| | Public debt exposed to FX risk (% of GDP) |
| Assessment of MT plans anchoring fiscal policy outcomes; and overall sound institutional budgetary framework as informed by recent fiscal ROSCs | |
| ***Financial sector soundness and supervision*** | ***Financial Sector*** |
| Capital adequacy and profitability: CAR (overall banking system and individual banks) | Capital adequacy ratio (%) |
| Return on equity (overall banking system and individual banks) | Return on assets (%) |
| Loan-to-deposit ratio | Loan-to-deposit ratio (%) |
| Share of external funding in total liabilities | Foreign liability (% domestic credit) |
| Credit to the private sector (real growth rate and share of GDP) | 3-year cumulative change in credit-to-GDP (%) |
| Nonperforming loan ratios (overall banking system and individual banks) | |
| Liquidity and funding risks: liquid assets to total liabilities; liquid assets to short-term liabilities | |

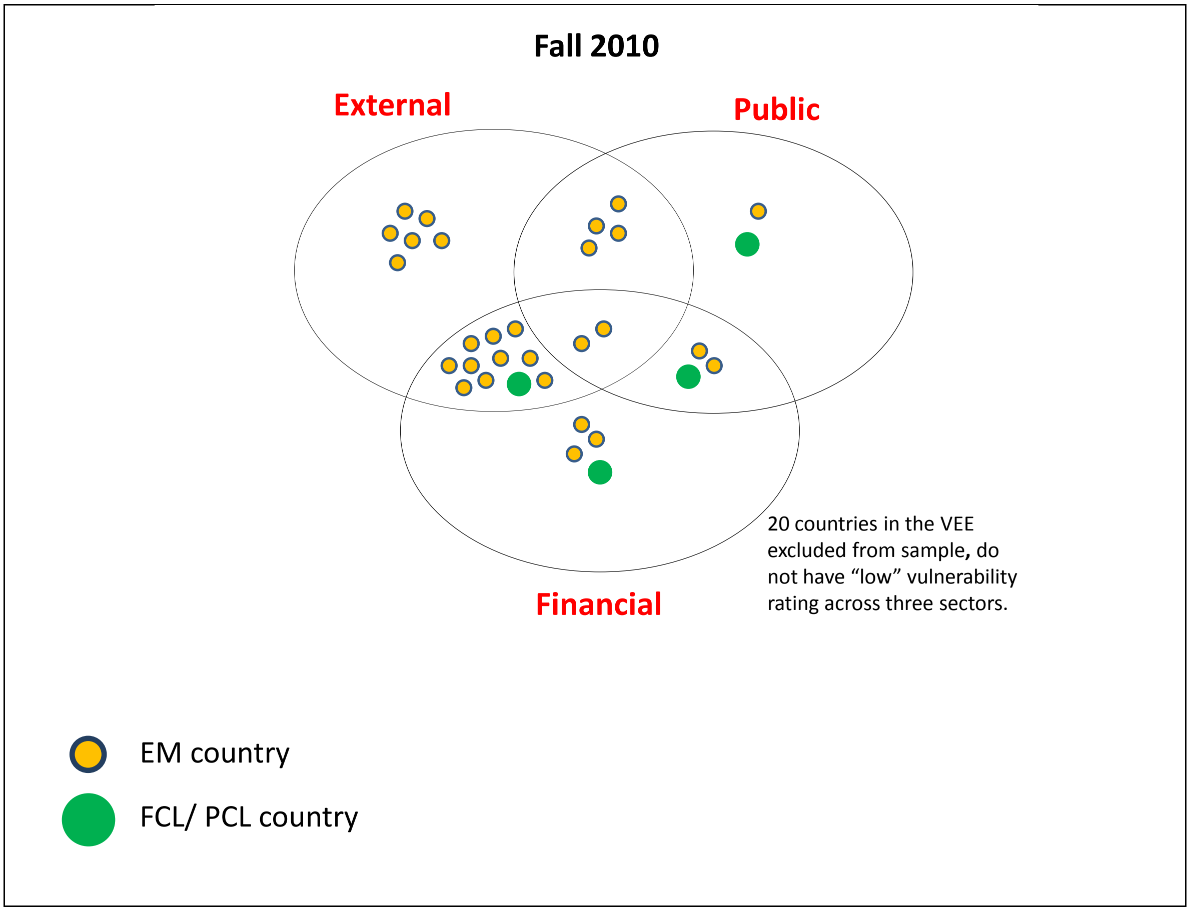
[28] These quantitative indicators are based on a strictly quantitative approach. Final ratings in the VEE are based on quantitative and judgment-based assessments.

[29] This may, however, come at the cost of transparency, since these ratings are strictly confidential. Moreover, the greater use of policy buffers possible due to the insurance provided by the FCL-PCL could affect the member's VEE rating. A disadvantage of such a change, however, would be the potential to undermine the independence of the VEE/VEA/VE-LIC exercises, if there were pressure to change the underlying methodology.

**Figure 6. VEE Venn Diagrams**
(Low vulnerability cases)





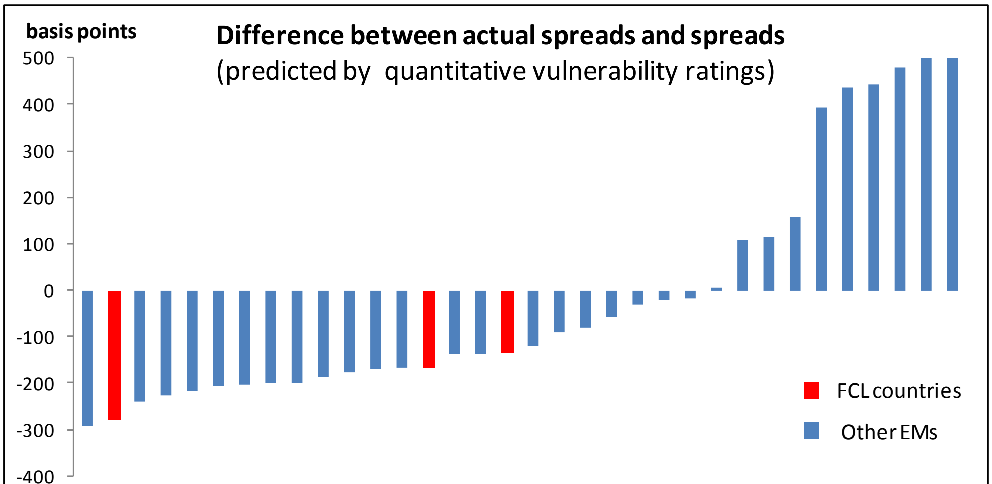

Source: Fund staff estimates.

**Qualitative and Institutional Assessment**

37. **Qualitative factors are, however, also critical to any qualification assessment**. This is particularly true since countries with FCL or PCL arrangements could be faced with shocks that require policy adjustment, and there is limited or no reliance on ex post conditionality to facilitate and monitor adjustment under these facilities. Institutional or qualitative factors are harder to gauge than quantitative factors, but are, nevertheless, an integral part of the current FCL/PCL qualification assessment framework, together with the quantitative indicators.[30] Comparing actual market spreads, which should capture all relevant information on country vulnerabilities with spreads predicted by the quantitative indicators described above, provides an indirect measure of these unmeasured qualitative factors. This is shown in the chart below: some countries—including all three FCL qualifiers—have large

[30] We construct an indirect measure of institutional quality using market prices and the above-mentioned vulnerability measures. Market-based assessments should summarize all relevant information about a country, and, if they are more favorable than suggested by quantitative vulnerability indicators, the resulting "gap" would be an indirect gauge of the robustness of a country's policy frameworks. (Of course other factors, including the liquidity of financial markets and gaps in the quantitative indicators, are also at play.)

negative "spread gaps" (starting from an already low spread base) due, presumably to strong qualitative attributes, not captured in a purely quantitative indicator-based framework.[31]




Source: Bloomberg, IMF staff calculations
A negative difference (i.e. lower actual spreads than predicted values) can be interpreted as a positive institutional "gap".

38. **A more focused discussion of these qualitative factors, including policy framework strength, would likely enhance FCL-PCL arrangements reports**. Many staff reports on FCL and PCL arrangements have not highlighted the qualitative and forward-looking aspects underpinning qualification in the discussion of qualification. In particular, much of the forward-looking discussion was often made outside the section covering qualification, rendering the discussion less focused. (Examples of discussion of qualitative qualification factors outside the qualification section in past reports are provided in Box 6.) Qualification discussion in FCL cases generally relied instead on the Board assessments of the most recent Article IV consultation, as well as letters from the authorities accompanying requests for new arrangements. While countries presently receiving support under FCL arrangements are very strong, future reports would benefit from a more in depth discussion of these aspects. Further elaboration in future requests should limit concerns over excess subjectivity, and should, over time, be helpful in better identifying the dividing line for qualification between FCL and PCL qualifiers. Additional guidance on the assessment of qualitative and forward-looking factors could be provided in amended FCL (and the forthcoming PCL) guidance notes, and would likely recommend the staff reports include, among other things, directly in the qualification assessment section, a description of the strength of the medium-term policy framework in all its main facets (including fiscal, financial, monetary, and external sectors).

[31] While in principle similar analyses could be undertaken for potential PCL qualifiers—although there are no prominent examples of such a list—lack of liquidity of market prices could be an obstacle in some cases.

### Box 6. Treatment of Past Policy Adjustment and Forward-Looking Assessments in FCL and PCL Arrangements Staff Reports

Current FCL/PCL staff reports cover the period since the start of the financial crisis in 2009, and as such contain several good examples of policy adjustment in response to shocks, and how the associated frameworks were modified where gaps were found. In contrast, assessments of policy frameworks are relatively scarce.

**Fiscal policy adjustment**

- The strengthening of the medium-term fiscal framework in **Poland** in 2010, including the additional corrective actions under the Public Finance Act and discretionary spending ceiling; the introduction of a fiscal rule and royalty reform in **Colombia** in 2010; the 2010 tax reform in **Mexico**; and the withdrawal of the fiscal stimulus during starting in 2010 for all three FCL countries.

**Adjustment of financial system policies**

- Strengthening of lending standards in **Poland**; changes of collateral and reserve requirements and extended repo maturities in **Poland**, credit guarantees and liquidity provision for the corporate sector in **Poland** and **Mexico**; the recommendation to retain bank profits to improve capitalization in **Poland** and **Colombia**; the high-level inter-agency committee financial system committee in **Colombia**; enhanced monitoring of corporate derivative positions and non-bank institutions in **Mexico**; the swaps with the ECB, Fed and SNB for **Poland** and **Mexico**; and the central bank law and creation of a Financial Stability Council in **FYR Macedonia**.

**Exchange rate policy adjustment**

- The discretionary foreign-exchange purchase program in **Colombia**; the options-based reserve accumulation strategy in **Mexico**.

**Forward-looking assessments**

- The medium-term fiscal strategy, including structural reform agenda, for **Colombia**; the debt management strategy and NIR floor in **FYR Macedonia.**

39. **The availability of a very recent Article IV, FSAP (and, if relevant, ROSCs) is very helpful in determination of qualification**. Both the FCL and PCL require that qualification assessments take into account judgments made in the context of "the most recent" Article IV consultations for the member, but do not specify any time limit after the most recent Article IV consultation staff report becomes "stale" and a new Article IV must be completed. A review of the minutes of FCL request Board discussions that were preceded by a recent Article IV consultation indicates that these discussions were far more streamlined and focused on FCL-specific issues, allowing Directors to refer to their Article IV statements for general economic background issues and qualification assessment. This was particularly true in the cases of Poland and Mexico's 2010 FCL requests, which took place shortly after Article IV discussions. By contrast, in the context of Colombia's most recent FCL request, where more than one year had elapsed since the Article IV discussion, a number of Directors complained that a more updated Article IV discussion would have allowed for a more in

depth assessment of Colombia's policies and vulnerabilities.[32] Reflecting on these concerns, the interviews of senior staff for the review noted that the process of undertaking an Article IV close to an FCL request helps ensure the availability of an up-to-date assessment of the strength of the member's institutions and policy frameworks. As Article IV consultation assessments age, their assessments can become dated quickly, especially in fast-moving circumstances.

40. **To the extent possible, therefore, and bearing in mind logistical constraints, Board discussions of FCL requests should be supported by a very recent completion of an Article IV consultation**. While a firm rule for Article IV timelines would conflict with the need to be able to put an arrangement in place quickly in an urgent case, there appears more scope in the case of successor arrangements (although even here, capacity and other constraints need to be factored in). To further bolster qualitative and forward-looking assessments, FSAPs (including updates that are due and FSAP stability modules) and relevant ROSCs should also precede FCL and PCL requests, where possible, taking into account logistical and resource considerations, rather than come after these requests.

41. **Qualification under the PCL raises additional issues**. There is a degree of subjectivity surrounding: (i) the definition of what constitutes a "substantial underperformance"; and (ii) the differences between PCL and FCL qualification criteria. Subjectivity is inevitable in any qualification scheme as noted earlier, however (unless bright line numerical thresholds were to be applied); nonetheless, additional clarity on these issues will emerge as the Board directly interprets these terms through its decisions in additional cases.

- **Substantial underperformance**. With only one PCL arrangement in place, analysis of past cases does not provide evidence on the interpretation of "substantial underperformance." At this stage, no clear alternative is evident. One possible approach is to supplement the existing approach with an informal consideration of VEE vulnerability ratings across various categories, as discussed above. (VEE rankings are based on weighted averages of performance across various indicators based on estimated crisis thresholds.) Of course, any such use would not be definitive and would supplement, rather than replace, the existing judgment-based approach to determining substantial underperformance.

- **FCL-PCL dividing line**. The ambiguity between the PCL and the FCL qualification criteria has been raised as an issue by several Executive Directors. The PCL has five "areas" within which qualification needs to be examined, while the FCL qualification framework is not defined in terms of areas but calls instead for an assessment of a

[32] At the time the note for the informal Board consideration of Colombia's third FCL request was circulated (April 4, 2011), the Article IV was already more than 12 months old (having been discussed on March 31, 2010). FYR Macedonia's 2009 Article IV was concluded on Dec 28, 2009, and the initial informal Board discussion was on Oct 29, 2010.

minimum of nine "criteria".[33] But the latter are only more specific indicators within the same five areas as those for PCL qualification, pointing to close similarity in the qualification assessments. As experience evolves, consideration could possibly be given to unifying the formulation of the areas to be assessed in qualification assessments across the PCL and FCL, as a means of making qualification discussions more comparable across arrangements.

42. **Separately, and despite reservations expressed by some over the role of the reserve qualification criterion, the review did not uncover any reasons why this should not remain part of the qualification assessment**. Given the nature of access under FCL and PCL arrangements, some interviewees questioned the need for a "relatively comfortable" reserve level as part of qualification where an FCL arrangement is requested on a precautionary basis. However, as discussed in Section III, these arrangements are principally intended as temporary reserve supplements for periods of heightened risk. The existing qualification criteria plays a useful role since inadequate reserves (for "normal times") are associated with heightened crisis vulnerabilities. A recent Fund policy paper, *Assessing Reserve Adequacy Metrics*, suggests using a risk-weighted metric that incorporates potential reserve loss from exports, short-term debt rollover, debt and equity outflows, and resident capital flight, as it outperforms other traditional metrics in predicting period of exchange market pressure. As such, this would seem—for most countries—to provide a suitable standard for reserve adequacy during normal times and could well be included in qualification assessments.

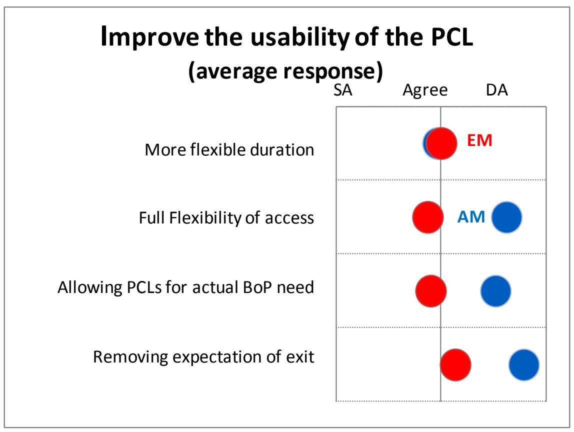
43. **To summarize, qualification assessments appear broadly appropriate, but treatment of qualification could be modified to address concerns about an overly narrow focus**. In particular, excessive reliance on quantitative indicators should be avoided, with the difficulties identified above suggesting that developing a quantitative "score card" for qualification as the sole basis for determining qualification is unlikely to work. Further emphasis on the forward-looking criteria applicable to the FCL-PCL is warranted, including by incorporating explicitly this discussion into the qualification section of staff reports. Focusing FCL and PCL staff reports on issues relevant for qualification assessments would also be aided by aiming to have in place wherever possible, taking into account logistical and resource considerations, a rigorous assessment provided by a recent Article IV consultation (and FSAPs/FSAP-updates/FSAP stability modules and, where relevant, ROSCs) available at the time a new arrangement is considered. In addition, further consideration should be given to whether unifying the areas in which qualification is to be assessed for the FCL and the PCL would provide additional clarity over time as to the relative qualification standards for the two instruments.

[33] The main reason for this difference appears to have been the potentially more limited nature of data availability in certain potential qualifiers.

## B. Instrument Flexibility

44. **Both the FCL and PCL were, in their design, made flexible in key respects**. In its initial inception, the FCL provided flexibility through: no ex post conditionality (other than a review at six months); in principle uncapped access (with an expected cumulative limit of 1,000 percent of quota); the ability to provide upfront financing; relatively long grace and repayment periods; possible successor arrangements subject to continued qualification; and the ability to be used to meet precautionary or present BoP needs upon approval. The FCL was enhanced in 2010 by the lengthening the duration of purchase rights to one year and removing the implicit 1,000 percent of quota access cap. The PCL shares many key features of the FCL, but in line with its lower qualification bar, it is less flexible in some respects: it can only be approved in the absence of actual BoP needs upon approval; it involves the use of streamlined ex post conditionality; it has shorter duration of purchase rights (maximum of 6 months after which completion of a review is needed to maintain access); and access is subject to an annual approval limit and an overall cumulative cap and is phased in arrangements longer than 12 months.

45. **There are, however, certain dimensions where additional flexibility could be considered**. This review explores some possible refinements that would make the instruments more flexible: (i) PCL arrangements to be approved to meet a present BoP need at the time of approval; and (ii) allowing approval of *shorter* PCL arrangements.




Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.
"SA" denotes Strongly agree, "DA" denotes Do not agree

### A PCL for *actual* BoP need

46. **A case can be made that a PCL arrangement should be made available to members facing a present BoP need at the time of its approval**. Survey respondents from emerging market members were generally supportive of allowing the PCL for actual BOP needs, while advanced country respondents had more reservations. A move to a PCL for actual BoP need would have three main advantages. It would: (i) better align existing instruments and facilities, enhancing the coherence of the Fund's GRA toolkit; (ii) address the difficulties of having to distinguish clearly between present and potential BoP need, particularly in crisis contexts in what can be fast moving conditions (see Box 7 for the case of FYR Macedonia); and (iii) provide greater flexibility by establishing an instrument that

can be used in a wider set of circumstances, and hence allow for a more adequate response to members' varying needs.

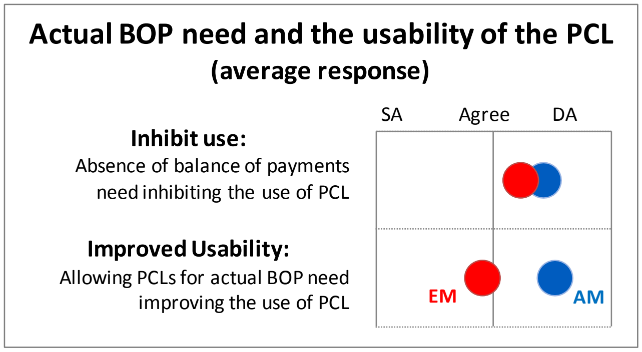
**Box 7. FYR Macedonia's PCL Arrangement**

**The experience of Macedonia, the first and the only PCL arrangement to date, illustrates the difficulty in differentiating potential and present BoP needs in a highly uncertain environment**:

- *Prior to the PCL arrangement approval*, the Article IV Consultation mission in mid-November 2010 assessed that Macedonia did not face a present BoP need, based on its economic fundamentals and policy commitment, as well as the global environment perceived at that point. However, immediately after the assessment, Ireland went into crisis and enormous downside risk was perceived for peripheral Europe in the following months. As FYR Macedonia's PCL Board meeting was scheduled two months away (in January 2011), there were substantial concerns (including from some Executive Directors) that Macedonia could be negatively affected by developments in peripheral Europe and end up with a present BoP need by the time of the Board meeting—this would disqualify FYR Macedonia for a PCL, even if its fundamentals and policy framework did not change. This experience suggests that whether a BoP need is potential or actual could largely depend on external conditions and could shift rapidly during a global crisis. In these circumstances, the member could be denied of a PCL arrangement when the country needs it the most (i.e., when hit by a severe exogenous shock).

- *Soon after the PCL arrangement approval*, FYR Macedonia drew under the PCL arrangement, citing impaired access to private markets that was needed to address external payments, due to uncertainties arising from unanticipated early elections. This raised questions by some Executive Directors as FYR Macedonia was assessed to have no present BoP need only two months prior. However, political developments and the possible negative impact on market access were unexpected at the time of the PCL approval and were difficult to project. This is another example how an actual BoP need could emerge quickly and it is hard to draw a clear line between a potential need and an actual need in the assessment ex ante.

47. **Unlike the PCL, the FCL can be approved to meet precautionary or present BoP need**. As the FCL was targeted at countries with very strong policies and fundamentals, and a sustained track record of implementation, it was designed with a dual purpose in mind: crisis prevention *and* crisis resolution. This was not the case for the PCL.




Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.
"SA" denotes Strongly agree, "DA" denotes Do not agree

48. **The main argument for a "drawing PCL" (i.e., a PCL arrangement approved where the member has an actual BoP need at the time of approval) is to bring greater coherence to the Fund's GRA toolkit**. Currently, both the SBA and the FCL can be used to meet potential *or* actual BoP need at the time of approval. In other words, countries expected to have both weaker *and* stronger policies than PCL-qualifiers have access to an instrument that can be approved where the member has an actual BoP need. The PCL is thus unique in this respect, as it is the only Fund instrument that expressly precludes approval unless there is an absence of actual BoP need.

49. **In support of such a drawing PCL, existing safeguards are numerous** and include: the combination of ex ante conditionality (qualification criteria); focused ex post conditionality to help address remaining vulnerabilities; prior actions where appropriate; short duration of purchase rights (no more than six months); a hard cap on access; and the phasing of access in arrangements longer than 12 months. In addition, the PCL is subject to the Fund's policies on exceptional access (where relevant), safeguards assessments, and post-program monitoring. In short, the PCL safeguards are almost as comprehensive as the SBA's with the very important additional comfort arising from the qualification framework that provides further assurances based on the strength of the member's policies and fundamentals. In this context, a PCL arrangement approved at a time when the member has a present BoP need would still provide adequate safeguards for Fund resources. From this perspective, disallowing access to PCL arrangements when the member faces actual BoP needs at the time of approval appears anomalous.

50. **A further argument for a drawing PCL is that in practice it can be difficult to distinguish between potential and actual BoP need, especially at times of market stress**. In rapidly-changing global conditions, a BoP need in a PCL-qualifying country that has been assessed to be potential can quickly morph into a present need without any change in the country's policies and fundamentals. In these circumstances, an instrument approved only on the basis of potential BoP needs like the PCL might be drawn on shortly after approval for fully defensible reasons. In such a case, there might be public confusion (and potential reputational cost to the member and the Fund), even though the BoP need was indeed only potential at the time of approval.

51. **Approval of a PCL arrangement in the face of both potential and actual BoP needs would also enhance the flexibility of the GRA toolkit and increase its attractiveness**. Members that meet all PCL qualification criteria, except the absence of an actual BoP need at the time of approval of the arrangement, might be discouraged from approaching the Fund if they face domestic political stigma sometimes associated with the SBA. Where present BoP needs in countries that meet all other PCL qualification criteria are not a signal of deeper structural or economic problems, addressing such needs through a PCL arrangement could result in a more effective financial engagement between the Fund and members.

52. **Finally, allowing for drawing PCLs would *not* undermine the instrument**. It is sometimes argued that a drawing PCL arrangement would represent a "light" form of SBA given differences in ex post conditionality, therefore blurring the line between the two instruments. But the differences between the SBA and PCL would remain major, even in the event of a drawing arrangement. The qualification criteria for PCLs are rigorous, and would remain rigorous for drawing PCL arrangements, whereas there are no qualification criteria for SBAs. In the event of a domestically-generated BoP need that indicated substantially weakened underlying economic strengths, the PCL would no longer be available (just as for an FCL arrangement at present). But in the event of a shock that leaves the member's basic economic and policy strengths more or less intact, there is no compelling reason to disallow a drawing arrangement from the outset, which leaves a clear dividing line between a drawing PCL arrangement and an SBA.

**A shorter duration FCL and PCL**

53. **A second way to enhance the flexibility of the FCL and PCL would be to allow for greater flexibility in arrangement duration**. Presently FCL arrangements can only be approved for a period of either one or two years, and PCL arrangements can be approved for any duration between one year and two years.[34]

54. **The key advantage of allowing shorter arrangements is that it would allow instruments to be better tailored to members' needs**. For member countries, more flexibility in duration could send clearer signals about the expected short term nature of any shock and the associated short term BoP need, or the time required to make credible progress in addressing its vulnerabilities during the course of the arrangement. For PCL-qualifying countries with remaining moderate vulnerabilities, shorter arrangements could signal the authorities' confidence in accessing private markets in the near term and a commitment to undertake prompt policy adjustment to address remaining vulnerabilities.

55. **However, too short a duration could complicate the application of the instruments**. Although it is possible to work out a menu of access limits and review schedules under a set of shorter duration arrangements, too much flexibility at the short end could make the menu overly complicated. These issues are less relevant in the case of the

[34] *The Fund's Mandate—The Future Financing Role—Reform Proposals*.

FCL, as it has no access limits, and no ex post conditionality outside of reviews. However, too much flexibility in FCL arrangements duration could also complicate review schedules.

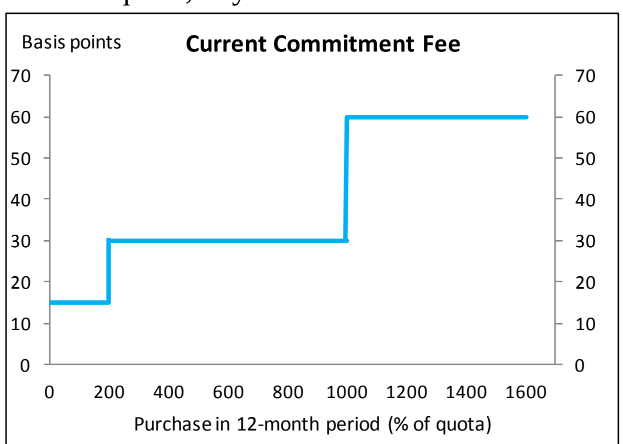
56. **Based on these considerations, and those in the companion paper, a possible approach is to allow limited additional duration flexibility for PCL arrangements**. Specifically, the PCL decision could be amended to allow the approval of PCL arrangements with a duration of six months in cases where the member has a short-term BoP need.

**Overall conclusions on flexibility**

57. **Overall, refinements to the PCL could enhance coherence of the Fund's toolkit, while better responding to members' varied circumstances**. There is a case on coherence grounds for establishing a "drawing" PCL arrangement. Given the difficulties associated with assessing precisely when crisis prevention becomes resolution, and the extensive safeguards already in place, approval of a PCL arrangement to meet actual BoP needs existing at the time of approval would be a welcome addition to the Fund's toolkit. Furthermore, allowing some limited additional flexibility in the duration of PCL arrangements would further enhance the responsiveness of these instruments to the varied circumstances of individual members.

## C. Commitment Fees

58. **The current fee structure attempts to strike a balance between several considerations, including simplicity, cost recovery, and deterring unnecessarily high and prolonged precautionary access**. The current structure sets commitment fees at 15 bps for annual access of up to 200 percent of quota; the commitment fee increases to 30 basis points for access between 200 and 1,000 percent of quota, beyond which it increases to 60 basis points (see chart).[35] This upward sloping schedule was aimed at limiting unnecessarily high and prolonged access, while not being so high as to discourage members from seeking precautionary arrangements of appropriate size. The current structure has the strong advantages of being simple, transparent, and predictable. A possible issue, however, is whether it strikes the right balance between meeting the members' desire for high precautionary financing and the need to ensure timely exit from Fund arrangements, thereby safeguarding the Fund's resources, given their limited nature.



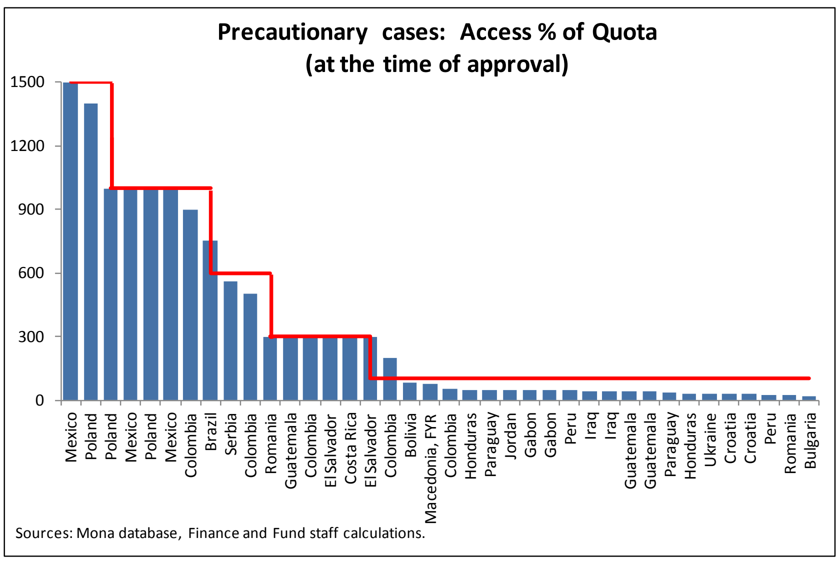
Source: Fund staff calculations.

[35] The commitment fee is levied upon approval of the arrangement and refunded on a pro-rata basis if drawings are made or if the arrangement is cancelled without being drawn in full.

59. **Whereas the survey results did not point to a need for urgent reform, some Directors have called for revisiting the incentive role of commitment fees**. Some Directors have argued for a redesign of the current commitment fee structure to improve price incentives and better reflect the impact of large commitments on the Fund's costs and liquidity position. In principle, several steps could be considered to better reflect both members' cost of acquiring reserves and the limited nature of Fund resources, including:

- ***A steeper fee schedule***. The slope of the fee schedule could be modified so that high access levels better reflect members' cost of accumulating reserves, e.g., as proxied by average EMBI spreads adjusted for a term premium.[36]

- ***A more graduated fee schedule***. Such a fee schedule would permit additional flexibility in matching the marginal commitment fee with access. Looking at Fund arrangements since 2000 that were either approved on a precautionary basis (including the recent FCL arrangements) or that became precautionary at some point during the arrangement, it can be seen that a number of natural "break points" stand out (see chart).




60. **While such moves would have advantages, they would also have serious drawbacks and the review does not point out a clear reform need in this area**. The drawbacks include:

- **Complexity**. As discussed, the current fee schedule, although ad hoc, is simple and predictable. Any change along the lines discussed would add complexity.

- **Incentives**. From the survey, interviews with mission chiefs, and experience under the FCL/PCL, it seems that commitment fees are not seen as a major issue. In

[36] This relates to the earlier point that EMBI bond durations are longer than that of the FCL.

particular, survey responses do not point to an urgent need for reform in this area. And excessive commitment fee increases could lead to a reduction in the already-low demand for use of the new instruments, increasing the danger that members would leave it too late before approaching the Fund for resources when hit by a shock. Introducing higher fees would also be at odds with the approach adopted by other organizations (including the World Bank and the Federal Reserve).

- **Spillovers**. As commitment fees are a form of "charges" under the Articles, they need to be "uniform" for all members (Article V, Section 8(d)). This provision does not require that charges be equal for all members, but differences in charges must be justified by differences in members' use of the Fund's resources (i.e., use of resources under different facilities). If commitment fees were to change, therefore, this would either call for (i) similar changes for all arrangements in the credit tranches, or (ii) redesigning the FCL and PCL to be special facilities outside of the credit tranches.

### D. Next Review

61. **It is proposed that the next review of the FCL-PCL take place earlier than the regular five year periodicity applicable to general policy reviews**. The Executive Board adopted a decision[37] calling for a joint review of the FCL and PCL decisions by no later than August 30, 2012, or whenever aggregate outstanding credit and commitments under these two decisions reach SDR 100 billion. This review of the FCL and PCL decisions was accelerated, and satisfies the requirement set forth in the above-mentioned decision. Under existing Board policy, the expected periodicity for most regular policy reviews is set at five years.[38] For the next review of FCL arrangements and PCL arrangements, however, staff considers that a shorter timeframe is warranted, and recommends that the next joint review be undertaken no later than three years after the completion of this review, or whenever aggregate outstanding credit and commitments under these two decisions reach SDR 150 billion.

## VI. Conclusions and Issues for Discussion

62. **Experience to date suggests that the FCL and, thus far, to a lesser extent, the PCL, have been successful in achieving their main objectives**. They have, during a period of heightened systemic risk, provided valuable supplementary insurance to members that qualified for the arrangements. This can be seen in the form of declining spreads and exchange rate volatility for users as well as in similarly-situated neighbors (albeit to a lesser

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[37] The Fund's Mandate – Review of Decisions on FCL Arrangement and PCL Arrangements", Decision No. 14717-(10/83), adopted August 30, 2010.

[38] The review of surveillance takes place triennially, and some policies are reviewed on an "as needed" basis, see: "Implementing Streamlining-Policy Review", Decision No. 13814-(06/98), adopted November 15, 2006; and "Omnibus Paper on Easing Work Pressures", Decision/A/13207, adopted August 28, 2009.

extent for the latter). This success likely reflects the distinguishing features of the new instruments, including the focus on ex ante conditionality based on the strength of members' policies and policy frameworks, as well as the availability of high upfront access where needed.

63. **Nonetheless, as perhaps demonstrated by the limited number of recipients to date, the instruments, and the practice surrounding their use, can still be improved**. In particular, concerns remain over ongoing stigma and subjectivity at the application stage. Stigma will likely only be addressed over time with experience of the new instruments. As for subjectivity, while judgment is critical and unavoidable, the review's recommendations for increased transparency should help address some of the remaining concerns. Additional emphasis could also be placed on the qualitative and forward looking factors already included in the qualification framework, with the discussion of these factors unified with other aspects of qualification in requesting documents. Finally, qualification would also be aided by aiming to have in place, wherever possible taking into account logistical and resource considerations, a rigorous assessment provided by a recent Article IV (and FSAPs/FSAP-updates/FSAP stability modules and, where relevant, ROSCs) available at the time a new arrangement is considered.

64. **As has been noted by the Board, access and exit are closely linked**. With these new instruments intended to provide additional insurance at times of heightened risks, access under successor arrangements should fall, as these risks subsequently dissipate. Closely linking access to the results of the assumed adverse scenario and other factors with a clearly justified link to the member's BoP need, and centering the discussion of the scenarios around the extent of tail risks assumed, should improve both transparency as well as the comparability of access across arrangements. Reforming the commitment fee structure is not seen as a pressing issue, although further investigation may be warranted in the future.

65. **Increased instrument flexibility could clearly improve the usability of the two instruments**. Specifically, there would appear to be strong merit in allowing for the approval of PCL arrangements where the member has an actual BoP need at the time of approval, which would improve the coherence of the GRA lending toolkit. Permitting shorter duration PCL arrangements would allow these instruments to be better tailored to individual members' needs.

66. ***Directors may wish to consider the following issues for discussion:***

- Do Directors agree that members have seen benefits from the creation of the FCL and PCL?
- Do Directors agree that more emphasis should be placed on the qualitative and forward-looking criteria already built into the qualification framework, while on the quantitative side, bringing in in-house vulnerability analysis? Should Article IV

timing be tailored more closely, where possible, to FCL or PCL qualification assessments?

- Do Directors agree that PCL arrangements should be allowed for qualifying members facing an actual balance of payments need at approval?
- Should PCL arrangement duration be made more flexible?
- What are Directors views on a possible steeper, or more graduated, commitment fee schedule, or do they agree that the present structure remains broadly appropriate?
- Do Directors agree that the next FCL-PCL review be undertaken jointly no later than three years from the completion of this review, or whenever aggregate outstanding credit and commitments under the two instruments reach SDR 150 billion?

## ANNEX I. CASE STUDIES

### A. Colombia and the Flexible Credit Line

***Main Message**. Since the creation of the Flexible Credit Line (FCL), three arrangements have been approved for Colombia. Qualification followed from Colombia's very strong rules-based policy framework, solid institutions, and very strong economic fundamentals. With a large share of commodity exports in external trade and relatively thin financial markets, adverse risk scenarios saw the major part of potential financing requirements arising from current, as opposed to financial, account shocks.*

***Contentious Issues**. Board discussion on the request for the third arrangement proved contentious on the issues of exit and the level of access. With the improved WEO and GFSR projections in April 2011, some Directors saw reserves as comfortable, raising concerns about possibly prolonged use of Fund resources under FCL arrangements. Along the same lines, the proposed increase in the access level was also questioned. Also, the timing of the FCL request proved a difficult area as more than a year had elapsed since the most recent Article IV consultation.*

***Context***. Following comprehensive reforms in the 2000s, Colombia had very strong fundamentals and institutional policy frameworks at the time of its FCL requests. These included a flexible exchange rate, a credible inflation targeting regime, strong commitment to a medium-term fiscal framework, and strengthened financial supervision. This setting contributed to strong economic performance prior to the recent crisis, including solid real GDP growth (5½ percent on average in 2004–08), single-digit inflation, low public debt (32 percent of GDP in 2008), and a sound financial system (average capital adequacy ratio of about 15 percent). However, the economic slowdown in Colombia following the Lehman bankruptcy was sharper than envisaged, with external conditions deteriorating in the form of higher sovereign spreads, weaker exports and worker remittances, and a sharply depreciating exchange rate. As the near-term outlook was cut sharply to zero growth in 2009 and the possibility of a further deterioration in the external environment was a concern, the authorities requested an FCL arrangement in April 2009 to provide insurance against downside risks. When the authorities requested the second arrangement in April 2010, the economy had already started to recover, in part owing to timely countercyclical macroeconomic policies and the robustness of the financial system, and the near-term outlook had been generally positive. However, the authorities still saw that significant downside risk remained, which continued to pose risks to Colombia's economy and external positions in spite of its very strong fundamentals. Staff concurred with this assessment and this view was maintained at the time the third arrangement was approved in May 2011.

***Role of the FCL***. Notwithstanding its very strong fundamentals, a protracted global crisis was seen as posing risks to Colombia's growth outlook and its balance of payments. Colombia is vulnerable to commodity price shocks, which could adversely affect both the current account and commodity-related FDI flows. As part of their wider policy response, the authorities requested FCL arrangements to boost confidence, support policies, as well as provide supplementary insurance against these risks. Other elements of the policy response included exchange rate flexibility and countercyclical macroeconomic policies. Staff agreed that the FCL would provide useful insurance against a further deterioration of global conditions, creating space to implement countercyclical policies without undermining market confidence and ensuring Colombia's continued access to international capital markets on favorable terms. While the global and domestic economic outlook improved later, in response to continued heightened global uncertainty the authorities saw that another successor FCL arrangement would provide protection against continuing external risks.

***Access***. The access level under each arrangement was determined by developing plausible adverse scenarios consisting of concurrent shocks to the current and capital accounts and estimating the resulting financing gaps. The scenario for the second arrangement was less severe than the one for the first arrangement in view of the more benign overall economic situation at that time. The scenarios for the second and third arrangements were broadly the same, but resulted in a larger access under the third arrangement due to a larger size of Colombia's economy and exports, and a larger share of the volatile commodity sector in the economy, which translated into a larger potential BoP need. The staff reports did not discuss the likelihood that these scenarios could materialize or the basis of the particular assumptions chosen.

- *First arrangement* (900 percent of quota, SDR 6.966 billion, for one year): Shocks were applied to oil prices, non-oil commodity prices, FDI flows, and rollover rates for public and private debt, to the baseline that had incorporated the shocks materialized after the Lehman bankruptcy. The access was presented as being in line with other high-access cases, including FCL arrangements for Mexico and Poland and, combined with reserves, providing adequate cover against these shocks.

- *Second arrangement* (300 percent of quota, SDR 2.322 billion, for one year): The authorities requested a lower access than under the first arrangement, arguing that the probability of a negative event had become lower and Colombia's reserve positions had become more comfortable following the SDR allocation. The adverse scenario included milder shocks to the same items as under the one for the first arrangement. While some Executive Directors argued that a lower access should be regarded as a step toward an eventual exit from the FCL, staff and the authorities maintained that the lower access was merely a reflection of the perceived risks.

- *Third arrangement* (500 percent of quota, SDR 3.870 billion, for two years): While the external conditions had improved, the authorities requested a successor FCL arrangement in view of the tail risks that remained elevated. They requested a higher access than under the second arrangement, arguing that a similar set of shocks would create a larger impact. This was evident from Fund staff's adverse scenario, which showed a larger gap resulting from broadly the same shocks, and so higher access would be necessary to provide the same level of protection. This resulted from the baseline scenario assuming larger commodity-related exports and investment inflows than before. Although a shock to worker remittances was added, its impact was small (US$275 million on average out of the total estimated shortfall of US$7.6 billion).

**Colombia: Main Assumptions Underlying FCL Access Calculation**

(Changes relative to baseline projections)

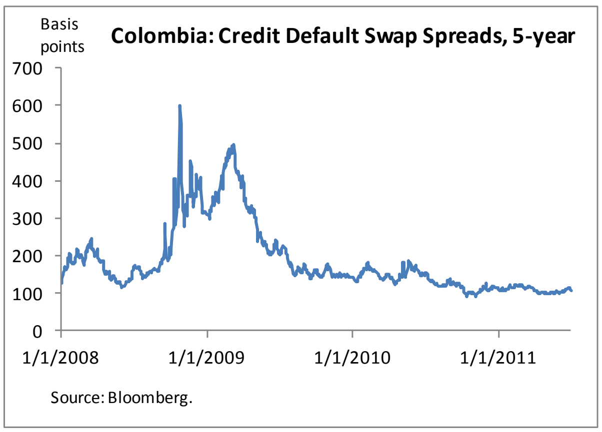
| | 1st FCL (May 2009) (SDR 6.966 bn.; 900 percent) | 2nd FCL (May 2010) (SDR 2.322 bn.; 300 percent) | 3rd FCL (May 2011) (SDR 3.870 bn.; 500 percent) |
|---|---|---|---|
| Fuel prices | 20% lower | 15% lower | 15% lower |
| Non-fuel commodity prices | 10% lower | 7.5% lower | 7.5% lower |
| Foreign Direct Investment | 15% lower in 2009; 10% lower in 2010 | 10% lower | 10% lower |
| Rollover Rates | 15 p.p. lower in 2009; further lower in 2010 | 10-15 p.p. lower | 10-15 p.p. lower |
| Worker remittances | n.a. | n.a. | 7.5% lower |
| Cushion Built in Access | SDR 1.5 bn. | SDR 0.14 bn. | SDR 0.30 bn. |
| Reserve Accumulation | 100% of baseline (negative) in 2009; 0% of baseline in 2010 | 0% of baseline | 0% of baseline |

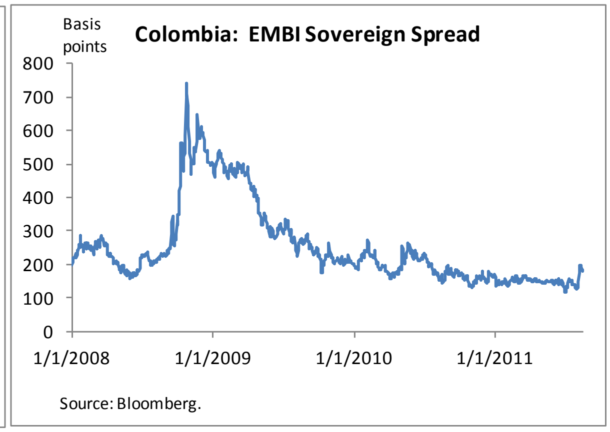
Source: EBS/09/65, EBS/10/67, EBS/11/61

***FCL and reserves***. The authorities indicated that it would have been impossible, and in any event undesirable, to build up quickly the level of reserves equivalent to the access under the first FCL arrangement—in other words, pursuing the self-insurance route—without compromising its macroeconomic policy framework, implying the FCL was seen as a substitute of sorts for higher reserves. At the same time, they also argued that access under the FCL was only an *imperfect substitute* for reserves as the FCL was a contingent instrument available only in the presence of a balance of payments need and, in line with Board decisions (BUFF/10/125), with access expected to decline as the macroeconomic situation normalizes with improving financing conditions resulting in a lower potential BoP need. In fact, the authorities have since March 2010 started accumulating reserves under a rules-based foreign exchange intervention and, when the third arrangement was requested, reserves had amounted to 6½ months of imports and exceeded 150 percent of the sum of external debt falling due and the current account deficit projected for 2011.

***Qualification assessment***. The staff reports highlighted that Colombia has very strong economic fundamentals and institutional framework and a sustained track record of implementing sound policies. Regarding the institutional framework, the reports referred to the rules-based medium-term fiscal framework, the inflation targeting and flexible exchange rate regimes, and the robust framework for financial regulation and supervision. They did not, however, assess the strength of the framework in light of the relevant international standards (except for data adequacy), partly because the fiscal ROSC and the FSAP were outdated. Staff reported quantitative indicators more intensively than qualitative assessments, including external debt, current account balance, FDI inflows, fiscal balance, and public debt in percent of GDP, as well as reserve numbers and capital adequacy, nonperforming loan, and provisioning ratios. Forward-looking assessment of policies and developments was made in the context of debt sustainability analyses and in the discussion of the reform of the fiscal framework, but not discussed in other areas apart from the authorities' commitment to maintaining the implementation of sound policies.

***Impact of the FCL***. The authorities and staff argued that the FCL contributed to stabilizing the expectations and created space for the authorities to conduct countercyclical policies. In the review of the first arrangement, staff reported that Colombia's bond spreads had been declining consistently faster than its Latin American peers. Staff also argued that market participants had repeatedly cited the strong supportive role that the FCL played in reducing perceptions of tail risks in Colombia. The announcement of subsequent FCL arrangements had less discernable positive impact on market indicators. For its part, Colombia's central bank carried out an analysis about the macroeconomic impact of the FCL, which shows that the first arrangement helped reduce bond spreads and increase consumer confidence, which led to higher GDP growth and lower inflation[1].






[1] "*Impacto macroeconómico de la línea de crédito flexible con el Fondo Monetario Internacional*," Banco de la República, March 11, 2011.

## B. FYR Macedonia and the Precautionary Credit Line

***Main Messages**. The Former Yugoslav Republic of Macedonia is the first and, to date, only country to have an arrangement under the Precautionary Credit Line (PCL). Qualification was based on strong performance across a variety of fiscal, monetary and financial indicators as well as overall sound institutional frameworks, but with moderate vulnerabilities remaining in the external sector and data quality. Citing a loss of market access ahead of unanticipated parliamentary election, and its shallow domestic debt market, FYR Macedonia made a purchase under the arrangement in March 2011. The first review under the PCL arrangement was completed in September 2011.*

***Contentious Issues**. Some issues arose related to the qualification of FYR Macedonia for a PCL arrangement and the purchase under the PCL arrangement shortly after the approval. On qualification, Directors were concerned about the health of the banking system (where the two largest banks are Greek), the adequacy of international reserves, and Macedonia's ability to access the sovereign debt market. But, in contrast, some Directors also would have supported a request for an FCL arrangement. On the purchase under the PCL, there were questions on whether the BoP need was actual, and concerns that the purchase could be driven by the Fund's below market lending rate for GRA facilities including the PCL.*

***Context***. FYR Macedonia weathered the 2008/09 global crisis relatively well, with only a modest recession in 2009 and a rapid recovery of international reserves from their low point in Spring 2009. Since 2010, the macroeconomic outlook has improved, with a gradual recovery, a rapid narrowing of the current account deficit, a moderate fiscal deficit, a sound banking sector, and broadly adequate international reserves coverage. However, as the financial turbulence in the Eurozone intensified through 2010, potential spillover risks became a major concern, especially given FYR Macedonia's large financial and trade linkages with Greece. Against this backdrop, the FYR Macedonian authorities sought deeper engagement with the Fund. They expressed interest in the PCL immediately after the establishment of the instrument in August 2010, and made a formal request in December, 2010. An arrangement was approved on January 19, 2011.

***Role of the PCL***. The PCL arrangement was taken to provide insurance against Macedonia's external risks. Despite sound fundamentals and policies and the absence of an actual balance of payment (BoP) need, external risks remained significant. The resources available under the arrangement would help ensure that Macedonia could better weather an adverse shock. Moreover, having a PCL arrangement in place would send a positive signal that policies were sound and that the authorities had adequate resources to draw upon if needed, which could strengthen investor confidence.

***Duration and Access***. The FYR Macedonian authorities requested a two-year arrangement with access of 500 percent of quota (SDR 344.5 million) in the first year and an additional 100 percent of quota (SDR 68.9 million) in the second year. A two-year arrangement was considered appropriate in light of the perceived persistence of external risks and the stronger signal that a longer insurance term would send. In addition, a two-year arrangement would bridge parliamentary elections originally scheduled in mid-2012 (later brought forward to June 2011; see below). The access levels could be justified under a reasonable stress scenario, which assumed lower EU growth in 2011−12 than in the Fall 2010 WEO baseline, an outflow of bank deposits in 2011 and only a partial return in 2012, loss of access to sovereign debt markets in 2011−12, and that international reserves could not be drawn down to below 85 percent of short-term external debt (at residual maturity). The Executive Board welcomed the requested access level which was below the cumulative access cap of 1000 percent of quota under a two-year PCL arrangement. Finally, FYR Macedonia was assessed to meet the four exceptional access criteria applicable to Fund arrangements beyond the normal access limits.

**FYR Macedonia: Main Assumptions Underlying PCL Access Calculation**

(Changes relative to baseline projections)

| | 2011 | 2012 |
|---|---|---|
| Cumulative Access level | SDR 344.5 million; 500 percent of quota | SDR 413.4 million; 600 percent of quota |
| Trade deficit 1/ | higher by 1.7% of GDP | higher by 0.6% of GDP |
| Current transfers 1/ | lower by 1.3% of GDP | lower by 0.4% of GDP |
| FDI inflows 1/ | lower by 1.3% of GDP | lower by 0.3% of GDP |
| Portfolio inflows 2/ | lower by €190 million | lower by €155 million |
| Bank deposits | Outflow of 5% | half of the bank deposit outflows in 2011 would return |
| Minimum gross reserve | 85% of ST debt at residual maturity | 85% of ST debt at residual maturity |

Source: IMF staff estimates.

1/ Assumes a 0.7 percent growth for the EU in 2011 and a 1.2 percent growth for the EU in 2012. Lower growth in the EU would affect the trade balance, transfers, and FDI.

2/ These are equivalent to no sovereign debt market access in 2011-12.

***Qualification***. Staff recommended approval of the request for a PCL arrangement. Macedonia was assessed to have a sound policy track record: it successfully completed several Fund arrangements and repaid the Fund early, and the Executive Board had a generally positive assessment of FYR Macedonia's policies in the context of the 2009 and 2010 Article IV consultations. FYR Macedonia was considered to perform strongly in three of the five qualification areas without substantial underperformance in any of the five. In short, it was seen as having: (i) a sustainable public debt position, with moderate fiscal deficits; (ii) low inflation within a sound monetary and exchange rate framework; (iii) sound financial sector balance sheets, with adequate supervision and regulation. Nonetheless, moderate vulnerabilities remained in the other two qualification areas: (i) external vulnerabilities arising from the current account deficit, the significant market share of Greek banks, and the overall exposure to developments in Europe; and (ii) shortcomings in data transparency and availability, including not subscribing to Special Data Dissemination Standard (SDDS), although data were adequate for surveillance and program monitoring purposes. Finally, at the time of approval FYR Macedonia did not have an actual BoP need and did not face any of the circumstances under which the Fund may not approve a PCL.[2]

The Board endorsed staff's assessment and approved the request for a PCL arrangement. Some Directors even suggested that FYR Macedonia could qualify for an FCL, but since the authorities did not request such an arrangement, the question was not considered by staff.

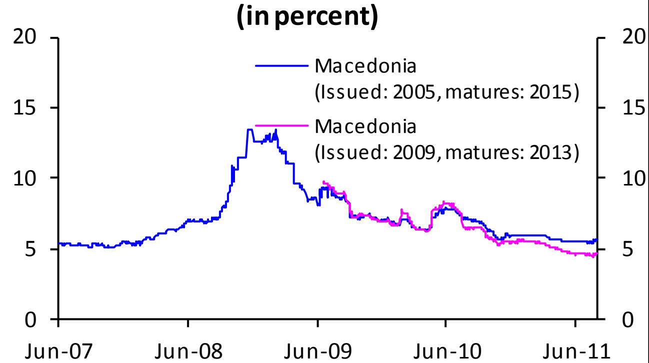
In general, the qualification assessment relied more on quantitative indicators than on qualitative ones, possibly due to the difficulty in evaluating FYR Macedonia's institutional framework, including the robustness of its fiscal financing framework (see more discussions below).

***Ex post conditionality***. The authorities' economic program focused on buttressing external and fiscal sustainability, mainly to limit external financing needs in an unfavorable external environment, and undertaking policy adjustments as needed in response to adverse developments. In particular, the arrangement includes indicative targets on the fiscal deficit and on net international reserves. The authorities also committed, in their written communication requesting a PCL arrangement, to improve data quality and to subscribe to SDDS, to strengthen the financial sector regulatory framework, and to undertake other structural reforms to boost long-term growth potential. Finally, as in all Fund arrangements, the standard performance criteria also applied.

During the Board approval of FYR Macedonia's PCL request, some Directors raised concerns over the robustness of FYR Macedonia's fiscal financing plan for 2011. They asked whether more could be done to strengthen the domestic debt market, as they saw risks in mostly relying on Eurobond issuances for budget financing. Staff argued that developing a domestic debt market would be a long-term project and no single quick fix existed. For the first PCL review, a structural benchmark on improving debt management was added.

***Purchase***. On March 30, 2011, the FYR Macedonian authorities purchased SDR 197 million (approximately €220 million, 286 percent of quota) under the PCL to meet the materialized BoP need, citing reduced market access and higher risks resulting from the announcement of early elections (originally scheduled in mid-2012).

**Eurobond Yields (in percent)**




Source: Bloomberg.

The authorities argued that meetings with external banks had led them to conclude that, due largely to the impending

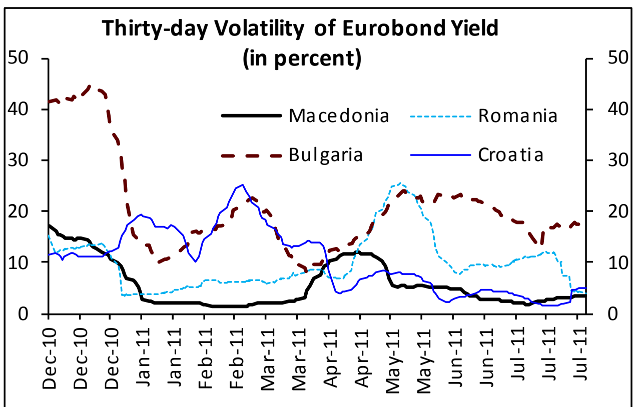
[2] These circumstances include: (i) sustained inability to access international capital markets; (ii) the need to undertake a large macroeconomic or structural policy adjustment; (iii) a public debt position that is not sustainable in the medium term with a high probability; or (iv) widespread bank insolvencies.

elections, they faced impaired access to external markets. The authorities had also explored tapping domestic markets but these were seen as too thin and skewed to shorter duration.

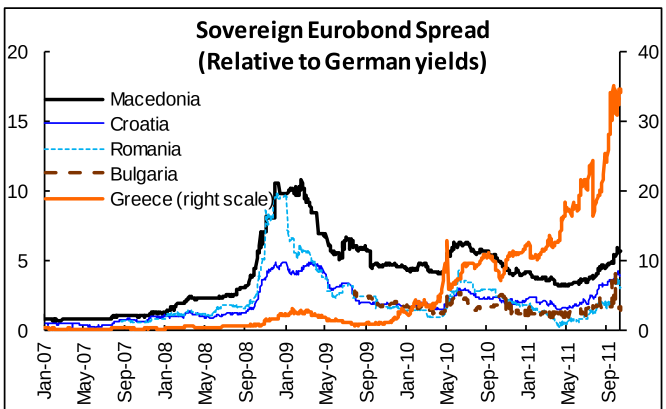
***First review***. The first review under the PCL arrangement was delayed—beyond the six-month anniversary of the arrangement's approval—due to the timing of the early elections and the time needed to form the new government. FYR Macedonia's performance was assessed to be broadly consistent with the program supported by the PCL. Nonetheless, staff assessed that the authorities' decision to draw on the PCL illustrated the remaining vulnerability in external and domestic market access, which was subject to both domestic and external risks. These vulnerability needs to be addressed by strengthened conditionality by improving debt management (with a structural benchmark on a roadmap). The target for international reserves was increased to send a positive signal of the authorities' intention to safeguard their stronger reserve position.

Directors supported completing the review and welcomed the structural benchmark on improving debt management, but raised questions on Macedonia's decision in March to draw on the PCL. A few Directors questioned the existence of an actual BoP need, and were concerned that the decision to draw could have been driven by lower costs of Fund financing. A few issues related to the design of the PCL were also raised by the Directors, including the possibility to shorten the repayment period, to extend the deadline for reviews under the PCL in exceptional circumstances, and the interpretation of "sustained" market access in the qualification criteria.

***Impact***. Despite the financial turbulence in Greece, the PCL helped boost market confidence in Macedonia. The secondary market yield of FYR Macedonia's 2015 Eurobond over that of Bunds narrowed since late 2010 (although spreads widened again in the fall of 2011 as euro zone financial tensions mounted), similar to the trend in other non-euro area countries in the region. Moreover, the volatility of FYR Macedonia's 2015 Eurobond yield went down significantly from November 2010, when Ireland went into crisis, to the approval of the PCL in January 2011. The decline in volatility was more pronounced than in other regional countries, possibly reflecting the positive signaling effect of the PCL. Since the approval of the PCL, the volatility of FYR Macedonia's 2015 Eurobond yield has remained lower than most of the other regional emerging markets.




Source: Bloomberg, Fund staff calculations.




Source: Bloomberg, Fund staff calculations.

## C. Mexico and the Flexible Credit Line

***Main Message****. Mexico was the first FCL arrangement, and is now the largest. Its three FCL arrangements provided an important source of insurance during the turbulent period that followed the global financial crisis, supplementing reserves seen as sufficient during normal times. Qualification was based on the central bank's successful track record as an inflation targeter, the rules-based fiscal framework, sustainable debt, reforms of the oil sector, as well as a sound set of macroeconomic indicators. In terms of access, the risks against which the authorities sought coverage varied over time.*

***Contentious Issues****. With Mexico's third FCL representing the largest single commitment of Fund resources, the impact of access on the Fund's liquidity position and exit triggers were highly contentious issues. Board discussions especially centered on the assumptions underlying the adverse scenarios. Mexico's performance relative to peers, the implications for the effectiveness of the FCL, and how the arrangement tied in with the authorities' reserve accumulation strategy were other controversial topics.*

**Context**. Mexico's first FCL was requested in April 2009 against the backdrop of the post-Lehman global financial shock and a rapidly-deteriorating near-team outlook. The peso was depreciating quickly, spreads were rising both for corporates and the sovereign and liquidity pressures were evident in the securitized market for housing finance and corporate paper. Growth was projected to fall sharply, to about minus 3¾ percent in 2009. Reserve cover, while considered adequate for normal times, was lower than some key emerging market peers, which had been noted by market participants and felt to have negatively affected sentiment. By the time of the review of the first arrangement, GDP growth had fallen over 20 percent (saar) in the first quarter of 2009, corporates had incurred major losses on foreign currency derivatives, prompting the authorities to draw on the Fed swap line to support that market segment, and there was an additional unforeseen shock in the form of the H1N1 virus outbreak, which hurt tourism badly. When the second FCL was requested in March 2010, it was clear that Mexico's 2009 growth contraction of minus 7 percent was the largest in the Americas, but also that the near-term outlook was now more positive. However, investor sentiment regarding the medium-term fundamentals in Mexico had worsened relative to that in other emerging markets, and concerns regarding advanced country sovereign debt had emerged, raising systemic risk. By the time of the third FCL request in December 2010, the need for insurance in the form of the FCL had increased, with progress towards global financial stability grinding to a halt, with fiscal concerns in the euro area periphery resulting in increased currency and capital flow volatility.

**Role of the FCL**. The authorities initiated a substantive crisis policy package from mid-2008— including the first foreign exchange intervention in a decade, a US$30 billion Fed swap line, and an unprecedented countercyclical fiscal policy package—and considered the FCL to play a key role for backstopping it, and thus enhancing its scale. At the time, there was major uncertainty regarding the scope and duration of the downside risks facing Mexico, with large non-residents' large portfolio holdings and the highly open capital account posing key risks. It was hoped that the FCL would protect the economy by providing support to the macroeconomic policy strategy, bolstering confidence until external conditions had improved, and complementing the Fed swap line (in place during most of the initial arrangement) and other IFI financing.

**Access** For the FCL to fulfill its desired role, the authorities argued that its size not only should be substantial, but suitably large to assure market participants that Mexico had the resources to maintain orderly financial conditions. By enhancing confidence sufficiently, it was argued, actual drawings would not be needed Hence, the intention to treat the FCL as precautionary was spelled out at the outset.

- ***First FCL***. A one-year arrangement with an access of 1,000 percent of quota (SDR 32 billion, about US$47 billion) was requested in order to bring Mexico's insurance (reserves and the FCL) up to the median of a sample of emerging market peers, without taking into account the Fed swap line. The adverse scenario in the Board document was not completely spelled out, but assumed a shortfall in external financing of about US$25-30 billion from reduced rollover rates, which together with investors' concerns about reserve adequacy and uncertainty regarding exposures added up to the above access level.

**Mexico: Main Assumptions Underlying FCL Access Calculation**

(Changes relative to baseline projections)

| | 1st FCL (April 2009) (SDR 31.53 bn.; 1,000 percent) | 2nd FCL (March 2010) (SDR 31.53 bn.; 1,000 percent) | 3rd FCL (January 2011) (SDR 47.29 bn., 1,500 percent) 1/ | |
|---|---|---|---|---|
| | | | 2011 | 2012 |
| Net exports, oil | not specified | 15% lower | 0 | 15% higher 2/ |
| Net services exports, incl. tourism | not specified | not specified | 5% lower | 10% lower |
| Net transfers, incl. remittances | not specified | 15% lower | 20 % lower | 25% lower |
| Foreign Direct Investment | not specified | 20% lower | 35% lower | 40% lower |
| Rollover Rates | 45 p.p. lower | 20 p.p. lower | 30 p.p. lower | 50 p.p. lower |
| Other Investment Outflows | not specified | $5 bn. | $10 bn. | $10 bn. |
| Cushion built in access | $20 bn. | $30 bn. | $25-35 bn. 3/ | $25-35 bn. 3/ |
| Reserve Accumulation | 100% of baseline | 100 % of baseline | 100% of baseline | 100% of baseline |

Source: EBS/09/126, EBS/10/81, EBS/11/11

1/ Two-year arrangement using independent shocks for 2011 and 2012 in the adverse scenario.

2/ Mexico is expected to became a net oil importer in 2012 and a lower oil price hence shrink the financing gap.

3/ Refers to the whole duration of the arrangement.

- ***Second FCL***. Despite the expiration of the US$30 billion Fed swap line, the requested access under the second FCL remained at 1,000 percent of quota, likely reflecting access being implicitly capped at that level. The adverse scenario was spelled out in more detail in the second request, showing impacts on exports, remittances, FDI, public and private sector rollovers rates for different instruments and terms, with more benign assumptions for the latter compared to the first request. Together, this accounted for a financing shortfall of about $20 billion or less than half of the requested access. To account for the expiration of the $30 billion Fed swap line, a cushion of that size was also built into the arrangement.

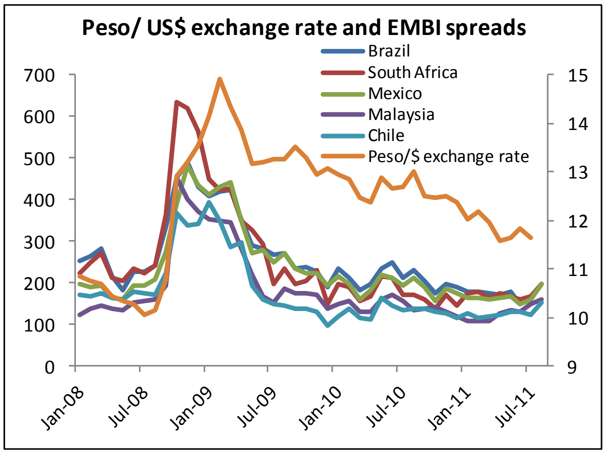
- ***Third FCL***. Access was increased to 1,500 percent of quota and duration extended to two years upon the approval of the third FCL arrangement. The authorities' motivation for the increase was two-fold: first, they wanted to take advantage of the Fund facilities reform as they saw the new features as better suited for insuring against the risks Mexico faced, and second, risks were lingering longer than expected. To justify the increased access, staff's adverse scenario applied independent shocks in 2011 and 2012, and allowed downside risks to increase over time in line with the WEO scenarios.

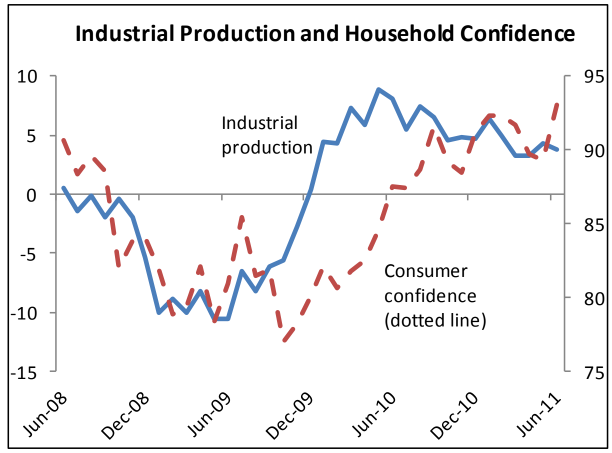
***Access and Reserves***. The authorities continuously pointed out the relatively close substitutability of Fund resources and own reserves across arrangements: in the request for the second arrangement it was noted that if the Fund through its mandate review were to come up with "suitably strong alternatives to self-insurance" it would be considered in their reserve accumulation strategy. The documentation of the third request also included the authorities' views of the reformed FCL being an increasingly close substitute to own reserves as a justification for increased access.

***Access and Risks to the Fund***. Throughout, staff noted that the sizes of Mexico's FCL arrangements were not out of line compared to other high-access cases. The third FCL arrangement, however, constituted the largest ever individual commitment of Fund resources, and its approval was preceded by intense Board discussions about the impact on the Fund's liquidity and other risks stemming from such a major exposure. The risks to the Fund were however concluded to be low, given the authorities' intention to treat the arrangement as precautionary, the fact that even full drawings would result in moderate debt levels with highly manageable service, and Mexico's excellent track record of honoring Fund obligations.

**Qualification**. In their assessment of the institutional framework for the first FCL, staff quoted the central bank's successful track record as an inflation targeter, the strong financial supervisory regime, the rules-based fiscal framework, the reforms of the oil sector, and the efforts to raise non-oil revenues. Additionally (and more extensively discussed than the above-mentioned qualitative criteria), staff found the quantitative criteria to be highly satisfactory. The assessment and relative emphasis on most of the quantitative criteria were very similar across the three arrangements, with the exception of reserves cover: while the first arrangement argued it to be adequate for "normal" times and easily meet traditional metrics and model-based benchmarks, the documents supporting the second and third requests mentioned the prudency of further reserve accumulation given investors' increased focus on lower coverage of balance sheet exposures relative to peers. The assessments of the forward-looking policy strategy were throughout based on the authorities' attached letters and the most recent Article IV consultations. References were also made to the October ROSC update, which found the overall quality of statistics to be good, as well as the 2006 FSAP update. The discussion of qualification criteria was fairly brief in all documents after the initial request.

**Impact of the FCL**. In the review of the first arrangement, staff argued that the FCL arrangement had supported a reduction in perceived tail risks and contributed to maintaining orderly conditions in financial markets. This was based on the strong recovery staged by Mexican spreads and the exchange rate around the announcement of the intent to seek support under the FCL, including compared to emerging markets peers. Later on, CDS spreads for sovereigns and corporates continued to fall, albeit less than for other emerging market peers, pointing to the relatively short-lived announcement effect of the FCL compared to e.g. the impact of investors' perceptions of stronger growth prospects elsewhere. In subsequent documents, focus was on the lingering external risks rather than any discernible impact of the FCL.




Left panel: Peso/US$ exchange rate. Right panel, left axis: Industrial production (y/y changes, 2001=100), right axis household confidence (levels, 2001=100).
Source:Bloomberg, Datasteram, Haver Analytics, and staff calculations.

## D. Poland and Flexible Credit Line

***Main Message****. Poland's strong performance during the global financial crisis was supported by its early adoption of, and continued access to, a Flexible Credit Line (FCL) arrangement with the IMF. The FCL helped lift investor confidence and helped maintain access to international capital markets, contributing to Poland avoiding outright recession. Qualification centered around overall strong quantitative risk indicators as well as a strong institutional framework--fiscal policy anchors, disciplined and transparent inflation targeting, and a strong supervisory system—that permit Poland to adjust well to shocks.*

***Contentious Issues****. The deterioration in the fiscal balance and still-large errors and omissions in the balance of payments were flagged by a few Directors as areas of weakness when assessing Poland's FCL eligibility. These issues have now been largely addressed by the authorities. Some Directors also questioned the proposed level of access at the time of the third agreement and its impact on the Fund's liquidity position. Finally, Directors also pointed to the absence of a clear exit strategy from the FCL while emphasizing the need for proper communication when considering exit.*

***Context***. Poland avoided the buildup of significant imbalances observed elsewhere in the region ahead of the global financial crisis through effective and timely policies. Despite entering the crisis with very strong fundamentals, a sharp deterioration in activity took place immediately in the aftermath of the collapse of Lehman Brothers, due to both real and financial spillovers. Export values contracted by 35 percent (year-on-year) and industrial output declined by 10 percent in early 2009. In addition, the interbank market froze in late October 2008 and a number of banks operating in Poland had difficulty obtaining foreign exchange liquidity. Exchange rate pressures were high, with the zloty depreciating by 30 percent against the euro through February 2009. Against this backdrop, Poland's first FCL was approved in May 2009 with one-year duration and 1,000 percent of quota in access. Nonetheless, by the time of the review in November 2009 it was already evident that Poland would escape a recession that year, supported by the authorities' timely policy action and in line with abating external pressures. Poland's request for a successor FCL arrangement in July 2010 took place amid renewed global financial strains in connection to developments in Europe's periphery. Poland's large trade and financial links with the euro area suggested possible large spillovers, implying significant downside risks to the near-term outlook. While there was a gap between the first and second FCL arrangements, market reaction was negligible as there was an expectation that a successor arrangement would soon follow upon expiration of the first arrangement. Finally, the November 2010 financial market turbulence in Europe represented another bout of acute uncertainty in Poland's external financing conditions, driving Poland's CDS spreads and government bond yields to about the levels seen in May 2010. These developments prompted the authority to request a new FCL in January 2011 with a two-year duration and larger access.

***Role of the FCL***. At the height of the global financial crisis, Poland's FCL arrangement, which boosted "insurance" by around 30 percent of reserves, was seen as important to maintaining market access and protecting against severe downside risks in light of the retrenchment in international capital markets. Furthermore, the availability of the FCL enhanced the authorities' policy space at this sensitive juncture, as it allowed a significantly higher fiscal deficit going forward, in support of growth, without unsettling markets. Poland's second FCL played a similar role during a period of renewed uncertainty. Furthermore, authorities and staff were of the view that, given Poland's regional importance, the FCL may provide insurance not only to Poland, but to the region more broadly. Poland's third FCL arrangement, by providing larger and longer insurance, was seen as allowing more time for external risks to dissipate while supporting investor confidence and macroeconomic adjustment policies going forward.

***Access***. In order to provide effective insurance against external tail risks, large FCL access is required to provide credible assurances of sufficient FX liquidity in the event that downside risks materialize. Furthermore, Poland's original FCL request argued that "access to the FCL in the amount of 1000 percent of quota … would reaffirm to markets the Fund's continued strong endorsement of [the authorities'] policies."

Poland's access under the FCL was set on the basis of plausible scenarios assuming concurrent shocks to various components of Poland's balance of payments meant to capture a tail risk situation. Shocks were concentrated on capital account items as these were assumed to be the most likely spillover channels of external financing stresses into the Polish economy.

**Poland: Main Assumptions Underlying FCL Access Calculation**

(Changes relative to baseline projections)

| | 1st FCL (May 2009) (SDR 13.69 bn.; 1,000 percent) | 2nd FCL (June 2010) (SDR 13.69 bn.; 1,000 percent) | 3rd FCL (January 2011) (SDR 19.166 bn.; 1,400 percent) |
|---|---|---|---|
| Foreign Direct Investment | 15% lower | 15% lower | 25% lower |
| Equity Portfolio Outflows | 10% of holdings | 5% of holdings | 10% of holdings |
| Rollover Rates | 20 p.p. lower | 10-20 p.p. lower | 20-25 p.p. lower |
| Other Investment Outflows | $2.5 bn. | $2 bn. | $4 bn. |
| Cushion Built in Access | SDR 2 bn. | $2 bn. | 0 |
| Drawdown of Private Foreign Assets | 10% of total liquid assets | 0 | 0 |
| Reserve Accumulation | 100% of baseline | 50% lower | 50% lower |

Source: EBS/09/57, EBS/10/128, EBS/11/5

Access under both the *first and second FCL arrangements* was 1,000 percent of quota. Against the backdrop of an implicit cap on access, this amount of access was deemed sufficient to bolster Poland's continued access to international capital markets assumed (first request) and to shield Poland against the potential spillovers, both direct and indirect, from the financing problems of some European sovereigns (second request). While large in terms of quota, relative to other indicators (such as GDP, reserves, exports), this access level was in line with other high access cases.

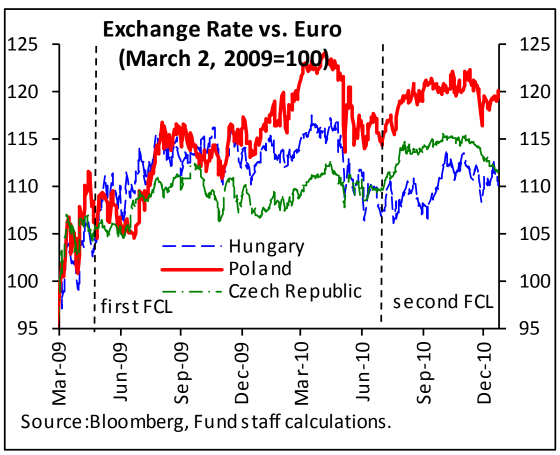
Access under the *third FCL arrangement* was increased to 1,400 percent of quota and extended to two years. The authorities considered the reform to Fund facilities undertaken in 2010 as providing enhanced flexibility both on access and length more in line with Poland's financing conditions and risks. This flexibility was not available at the time of the initial two requests. Furthermore, ongoing risks in financial markets, particularly within Europe, justified the need for a sufficiently large and prolonged buffer against tail risks. Given heightened external risks since the previous arrangement, the assumptions applied were somewhat more severe and, in some cases, more in line with Poland's experience during the 2008–09 crisis, while still comparable to other FCL cases.

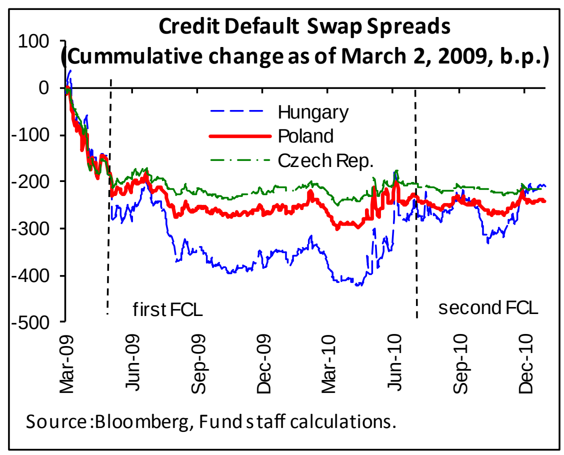
***Access and reserves***. Poland's international reserves have been on a steady upward path, increasing from about US$40 billion in 2004 to about US$100 billion in 2010**.** While reserves are more than adequate for normal times on several measures, they fall short of short-term debt at remaining maturity plus the current account deficit, supporting staff's view that some additional reserve accumulation would be desirable. On the other hand, Poland's authorities consider reserves to be more than adequate, with the FCL providing an additional backstop in periods of heightened external risks. Access under the current FCL helps to expand Poland's "insurance coverage" to around US$126 billion, which would, on an augmented reserves basis, bring them closer to the international median ratio of international reserves to short-term liabilities.

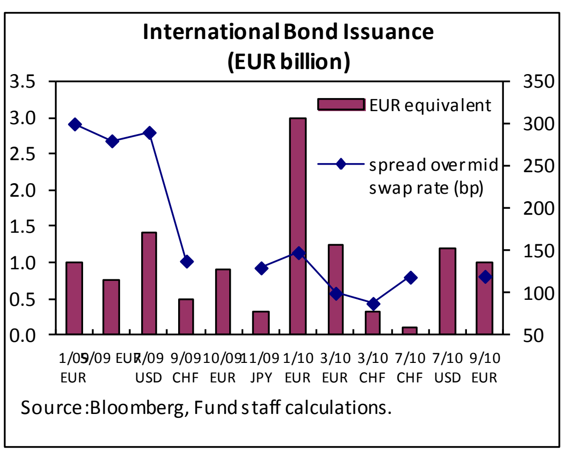
***Qualification***. As stated in the staff report's accompanying Poland's FCL requests, Poland's continued FCL qualification is supported by the country's very strong economic fundamentals and institutional policy framework, together with its sustained track record of implementing very strong policies. Indeed, Poland's authorities have been praised by both staff and the Board for their strong and timely response to the global financial crisis, which enabled Poland to be the only EU country to escape a recession in 2009. This policy response was facilitated both by the room for maneuver afforded by Poland's limited external and internal imbalances entering the crisis and by the FCL. Poland was assessed to satisfactorily meet those criteria related to macroeconomic indicators (sustainable external position, low and stable inflation, adequate reserve position). Similarly, criteria based on the quality of institutional framework were also positively assessed: (i) fiscal policy is guided by achievement of the Maastricht criteria and remains underpinned by the Polish Public Finance Act—prompting corrective action when public debt reaches trigger levels of 50 and 55 percent of GDP—and by the Constitutional ceiling on public debt of 60 percent of GDP; (ii) a disciplined and transparent inflation targeting framework supported by a flexible exchange rate regime; and (iii) a supervisory framework that has been further strengthened in line with the recommendations of the 2006 FSAP Update and has managed to substantially limit risks related to FX-mortgage lending.

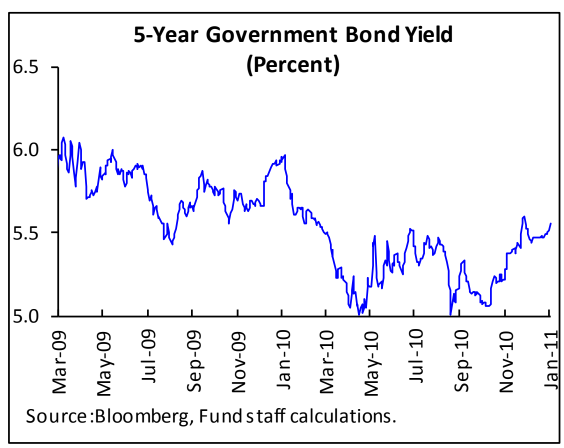
Despite its strong economic fundamentals, two issues have been raised regarding Poland's continued FCL qualification. First, concerns arose over the relatively high fiscal deficit (7.8 percent of GDP in 2010) and debt levels, mostly stemming from the counter-cyclical support during the downturn. Substantial fiscal consolidation is now underway, with the deficit currently expected to fall to around 5½ percent of GDP in 2011. Second, there were concerns about the large and persistent errors and omissions in the balance of payments. This issue has been largely addressed by the authorities with the support of Fund Technical Assistance. These large errors and omissions largely stemmed from under-reported imports of used cars and over-stated private sector transfers. Properly accounting for these two items has reduced the size of errors and omissions from around 4 percent of GDP to less than 2 percent. The authorities are still working on further reducing the size of errors and omissions.

***Impact of the FCL***. Both authorities and staff concur that access to the FCL arrangement since May 2009 has served Poland's economy well. The FCL has allowed for a more flexible policy response to the global crisis while preserving favorable access to markets, even as volatility has remained elevated. The review of the first FCL concluded that "strengthening of the zloty, reduction in sovereign external spreads, increasing capital inflows, and declining yield on government bonds have in part reflected the stabilizing impact of Poland's FCL agreement." The authorities have also indicated that access to the first FCL was helpful to allow a more flexible policy response, including the acknowledgement of considerably larger increase in demand in the domestic bond market—which saw a return of foreign investors especially after April 2009—and the subsequent decline in yields. Moreover, after the approval of the first FCL arrangement, the government was able to tap successfully international markets with long-term bond offerings that were significantly oversubscribed. At the current juncture, with policy space to respond to external shocks now more limited, sustained access to the FCL continues to provide an important buffer against external shocks and supports robust policy frameworks.



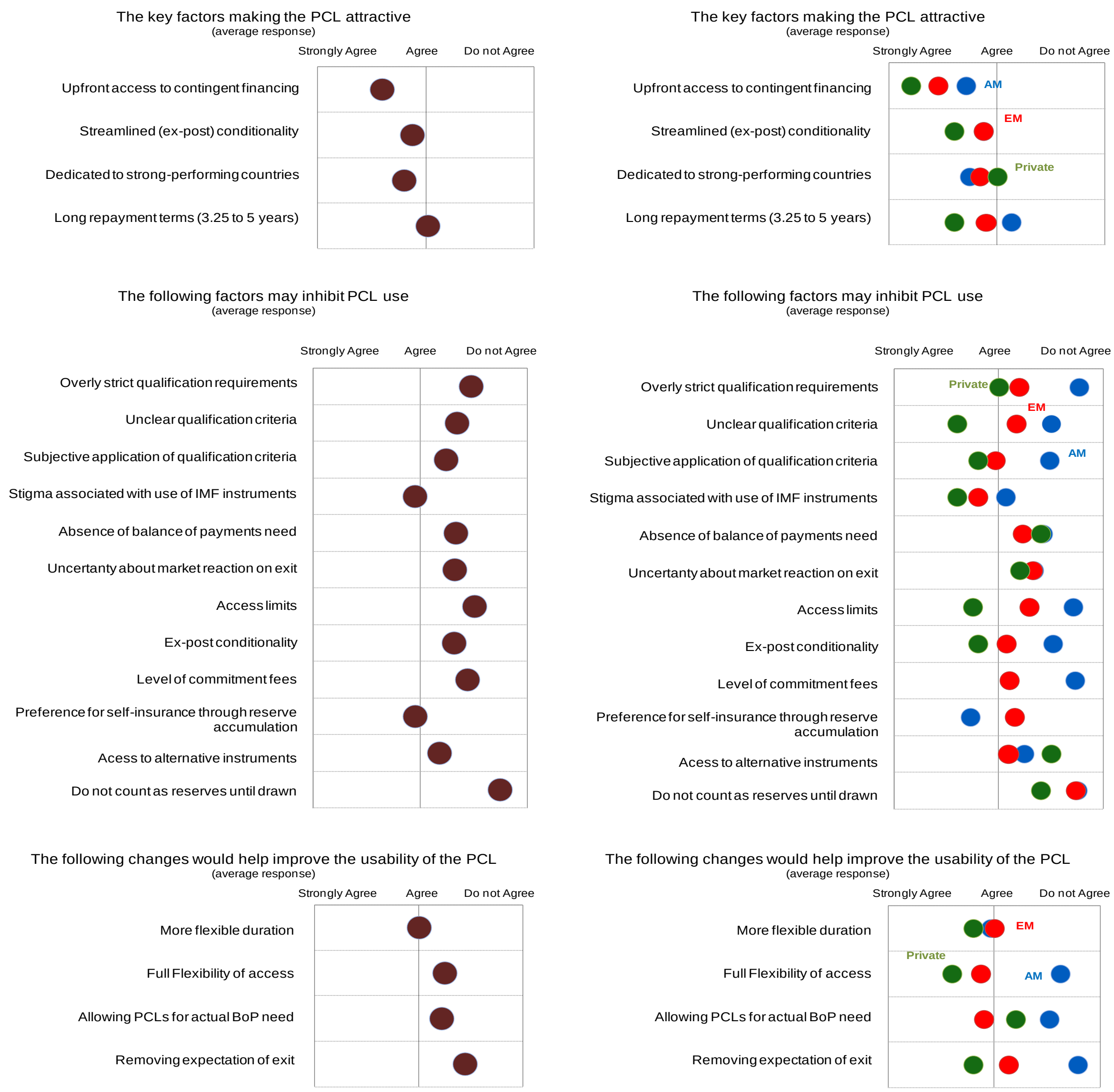
## ANNEX II. SURVEY RESPONSES

***We surveyed member country authorities and private sector analysts** on the features that (i) make the FCL and PCL attractive; (ii) inhibit their use; and (iii) could be improved. Overall the response rate from member countries represented almost 80 percent quota shares. Slightly more than half (55 percent) of the responses came from advanced countries, with the remainder from emerging market countries. Responses from central banks and Ministries of Finance were almost evenly divided. Separately, the survey was sent to 60 private sector analysts (including academics, banks, rating agencies and hedge funds), with a response rate of almost 20 percent.*

### FCL Survey Responses[1/]


Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.
1/ The aggregated responses displayed in the left column are the average of the responses received from county authorities and do not include the responses from the private sector.

## PCL Survey Responses[1/]




Source: Fund survey of country authorities on the FCL and the PCL; and staff calculations.

1/ The aggregated responses displayed in the left column are the average of the responses received from county authorities and do not include the responses from the private sector.