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Review of the Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument - Specific Proposals

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IMF POLICY PAPER

April 30, 2014

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

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

- The **Staff Report** on The Review of the Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument – Specific Proposals, prepared by IMF staff and completed on April 30, 2014 for the Executive Board's consideration on May 21, 2014 and June 11, 2014.

The following documents have been or will be separately released.
A **Press Release** summarizing the views of the Executive Board as expressed during its May 21, 2014 and June 11, 2014 consideration of the staff report
Revised Annex I on The Review of the Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument – Specific Proposals. *

*Also included in Staff Report
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REVIEW OF THE FLEXIBLE CREDIT LINE, THE PRECAUTIONARY AND LIQUIDITY LINE, AND THE RAPID FINANCING INSTRUMENT—SPECIFIC PROPOSALS

EXECUTIVE SUMMARY

This paper responds to Directors' request at the time of the February discussions of the Review of the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL) and the Rapid Financing Instrument (RFI) for further analysis focusing on three key issues:

- **The alignment of the FCL and PLL qualification criteria**. The paper proposes a qualification framework for PLL arrangements based on the nine FCL criteria aiming to improve the transparency and predictability of PLL decisions, while maintaining the current qualification standards. The paper also proposes a refinement of the bank solvency criterion.

- **The operationalization of an external stress index**. The paper proposes a methodology to calculate a new index to strengthen discussions of a country's external risks. Such an index would be presented to the Board at the time of requests for, or reviews under, FCL and PLL arrangements.

- **The use of indicators of institutional strength**. The paper argues that a limited set of new institutional indicators could be used to help broaden the indicators of institutional strength already identified in the FCL and PLL Operational Guidance Notes.

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CONTENTS

INTRODUCTION

1. **This paper responds to Directors' request at the time of the February discussion of the Review of the FCL, the PLL, and the RFI for further analysis and proposals to enhance transparency and predictability in qualification assessments, and access and exit discussions.** At the February Board meeting, Directors considered that the FCL and the PLL have provided valuable insurance to members against external shocks and helped boost market confidence during periods of heightened risks. They saw, however, scope for further refinements, and welcomed efforts to enhance the effectiveness, transparency, and attractiveness of these instruments. Specifically, Directors underscored that assessing external risks remains an important aspect of access and exit discussions. In this regard, most Directors supported the development of an indicator of external stress, along the lines proposed by staff, considering that it would be a useful innovation to strengthen the discussion of a country's external risks in staff reports for requests for, or reviews under, FCL and PLL arrangements. Most Directors were also open to the idea of developing selected indicators of institutional strength to complement existing indicators of qualification. In addition, most Directors saw merit in aligning the criteria for qualification assessments between the FCL and the PLL, while maintaining the different qualification standards for each instrument as under the current policies. During the meeting, Directors saw no need to further review or amend policies governing the RFI at this stage.

2. **This paper considers these three issues,** making specific recommendations on each. These include proposals to unify the FCL and PLL qualification criteria (Section II); operationalize external risk indices (Section III); and broaden the use of indicators of institutional strength (Section IV).

3. **The paper also considers the case for amending the bank solvency criterion** (Section II). The current FCL criterion sets a relatively low qualification bar for the soundness of the financial sector expected of FCL qualifying members. Also, as formulated, it does not allow for sufficient differentiation between potential FCL and PLL cases.

FCL AND PLL QUALIFICATION CRITERIA

A. Alignment of the Criteria

4. **In the recent Board discussion many Directors saw merit in adopting the FCL qualification criteria for PLL qualification assessments**. They recognized the inherent challenge in identifying the minimum standard needed to meet the PLL qualification requirements and supported the alignment of the qualification criteria between the FCL and the PLL for the purpose of enhancing the richness, predictability, and granularity of PLL qualification assessments and for making qualification discussions more comparable across arrangements. They also stressed the need to preserve the high standards of the FCL, noting

the broadly satisfactory decisions on FCL qualification, and the need to maintain the different qualification standards for these instruments.

5. Existing similarities between the two instruments facilitate the adoption of the FCL qualification criteria for PLL qualification assessments. While the qualification frameworks for the FCL and the PLL currently differ, they both cover the same five broad areas—namely, external position and market access; fiscal policy; monetary policy; financial sector soundness and supervision; and data adequacy. Specifically, qualification for the FCL is based on nine specific criteria broadly under these areas, while PLL qualification assessments are based on performance in these five broad areas, which could possibly draw on the nine specific FCL criteria (Table 1 shows the mapping between the two).[1] Notwithstanding the similarities, modifying the current PLL qualification assessment framework to align it with the FCL qualification framework is not straightforward.

Table 1. Specific Qualification Criteria for the FCL and Broad Qualification Areas for the PLL

PLL Qualification Area	FCL Qualification Criterion
I. External Position and Market Access	**1.** Sustainable external position **2.** A capital account position dominated by private flows **3.** A track record of steady sovereign access to international capital markets at favorable terms **4.** A reserve position that is relatively comfortable when the arrangement is requested on a precautionary basis
II. Fiscal Policy	**5.** Sound public finance, including a sustainable public debt position determined by a rigorous and systemic debt sustainability analysis
III. Monetary Policy	**6.** Low and stable inflation, in the context of a sound monetary and exchange rate policy
IV. Financial Sector Soundness and Supervision	**7.** Absence of bank solvency problem that pose an immediate threat of a systemic banking crisis **8.** Effective financial sector supervision
V. Data Adequacy	**9.** Data transparency and integrity

6. In modifying the basis for PLL qualification assessments, it is important to maintain essentially the same qualification standard. In using the nine specific FCL qualification criteria for PLL qualification assessments, consideration needs to be given to how best to maintain the PLL qualification requirement that a country should perform strongly in "most" of the areas as specified in the PLL decision. Under the current PLL policy, strong performance in "most" areas is interpreted as strong performance in at least three out of five PLL qualification areas, with no substantial underperformance in any area. Extending this requirement to a new qualification framework based on the nine specific FCL criteria is

[1] In addition to the qualification criteria, PLL qualification is subject to four approval criteria, see ¶8.

complicated since two PLL qualification areas encompass more than one FCL qualification criterion and it is difficult to impose the current PLL qualification standard vis-à-vis the nine specific qualification criteria. Simply extending the requirement of strong performance in three out of five qualification areas to no less than seven out of the nine criteria would make the qualification requirement for PLL arrangements stricter. Allowing, however, for less than strong performance in three or four criteria could weaken the current qualification standard, as these could entail less than strong performance in more than two of the existing five PLL qualification areas.

7. **To address this issue, staff proposes that PLL qualification be assessed as follows**: First, the FCL qualification criteria will be explicitly incorporated into the PLL decision and grouped under the five broad qualification areas. Second, given that the qualification standards for the PLL should remain unchanged, the qualification under the PLL should continue to be based on the member being expected to perform "strongly" in most of the five qualification areas (i.e., in three of five areas), as indicated in Table 1. Substantial underperformance in any qualification area would signal that the member does not qualify for a PLL arrangement. In assessing the member's performance under the qualification areas, staff will take into account the nine qualification criteria and indicators currently used in the PLL Operational Guidance Note. Qualification would be broadly assessed against the five qualification areas without any precise "scoring" of the nine qualification criteria. While the proposed framework would not differ substantively from the current practice under the PLL,[2] it would make clearer the criteria against which a member will be assessed for a PLL arrangement, improving transparency and predictability of decisions and would allow for comparability across arrangements, while maintaining the current qualification standards for this instrument.

8. **It is proposed to maintain the four disqualifying circumstances for PLL arrangements**. Specifically, the Fund will not approve a PLL arrangement for a member facing any of the following circumstances: (i) sustained inability to access international capital markets, (ii) the need to undertake large macroeconomic or structural policy adjustments (unless such adjustment has already set credibly in train before approval), (iii) a public debt position that is not sustainable in the medium term with a high probability, and (iv) widespread bank insolvencies.

B. Bank Solvency Criterion for the FCL and the PLL

9. **The current FCL qualification criterion on bank insolvency seems weaker than would be commonly expected for an FCL user**, that is, for a country with very strong economic fundamentals, institutional policy framework, and policies. The alignment proposal—basing PLL qualification on the nine FCL criteria—has prompted staff to look again at the individual criteria. The current criterion relating to bank solvency—"the absence of bank

[2] See Annex I of the Precautionary and Liquidity Line – Operational Guidance Note.

solvency problems that pose an immediate threat of a systemic banking crisis"—appears insufficiently rigorous, given the large risks involved and the deep and disruptive nature of these problems.[3] Also, unlike the other criteria, it does not provide scope for differentiation between PLL and FCL cases. In practice, it is far below the state of financial sector soundness seen in the current and previous FCL and PCL/PLL users (with all of these countries assessed as performing strongly in financial sector soundness and supervision).

10. Accordingly, it is proposed that the bank solvency criterion be amended so that it is based on the overall strength of the financial system. At the same time, since the PLL can be used as a disbursing arrangement when there is actual balance of payments need, there should be room for approving arrangements in cases where the country may have moderate issues in the financial system provided they are addressed under the arrangement. Specifically, the criterion for the FCL and the PLL is proposed to be reformulated as follows: "Sound financial system and the absence of solvency problems that may threaten systemic stability." Compared with the current criterion, this would: (i) broaden the focus to the financial system from the banking sector, (ii) introduce the concept of soundness of the financial system, and (iii) raise the bar for systemic instability to potential as opposed to immediate threat. All current and past FCL/PCL/PLL users would meet the terms of the proposed new criterion.

INDEX OF EXTERNAL STRESS

11. The assessment of external risks is critical to both the justification of access and the prospects for exit from use under the FCL or PLL. In this regard, at the February Board meeting most Directors considered that an indicator of external stress, along the lines proposed in the Board paper, would be a useful innovation to strengthen the discussion of a country's external risks in staff reports for requests for, and reviews under, FCL and PLL arrangements. As underscored in the paper, the index would be an indicator of the evolution of the external environment as it pertains to the particular member, and would aim to help inform discussions of access and exit prospects.[4] In this section, a general and flexible methodology is outlined to guide staff in constructing such indices tailored to a member's specific economic situation. The development of the index would be undertaken by individual country teams, after discussion with the authorities, as part of the preparation of a staff report on an FCL/PLL arrangement. The methodology serves as a basic framework to be used in relevant staff reports for members using these arrangements, but is flexible to permit tailored applications to different country cases and refinements by mission teams.[5] To allow the Board to assess relative

[3] This issue did not arise at the February review as staff had proposed the use of the five PLL qualification areas for FCL qualification assessments. However, many Directors preferred instead to enhance PLL qualification assessments by using the nine FCL qualification criteria.

[4] This index is not intended to help inform qualification decisions, which are subject to the qualification framework.

[5] However, any use of the index would be based on broadly applicable principles that ensure uniformity of treatment among Fund members so that similarly situated members will be treated similarly in the use of Fund resources under the FCL and PLL.

risks over time, the risks, variables, and weights, once decided, would be expected to remain set throughout the duration of an arrangement, absent a compelling economic reason which should be presented clearly in the report.

12. Any index will, broadly, require three main choices: (i) the selection of the key external *risks* facing the country; (ii) the selection of proxy *variables* capturing these risks; and (iii) the choice of the *weights* to apply to each of these variables. The index will be a weighted sum of standardized deviations of the external proxy variables from their means. Staff will discuss these key modeling choices with the relevant country authorities, although staff will ultimately be responsible for making these decisions.

- **Risks.** The principal external risks specific to a country are typically identified by country teams in Article IV consultation staff reports, following discussion with country authorities, including drawing on risks identified in the Global Risk Assessment Matrix (G-RAM). Key vulnerabilities could include, for example, portfolio and cross-border bank flows, exports to key trading partners, workers' remittances from a single country or region, and commodity prices changes for commodity exporters.

- **Variables.** Each risk would be represented by proxy variable(s) that capture(s) the external factors relevant to the risk. For example, if exports to the Eurozone are a key risk, Eurozone growth could be the external proxy variable. Risks associated with portfolio debt liability risks could be linked to US treasury yields, and equity portfolio investment could be related to volatility in emerging markets.

- **Weights.** Different methods can be used to calculate the weights for the selected variables, depending on data availability and relevance of different techniques. As the default, simple statistics could be used to derive the weights (data-based). However, where appropriate and feasible, country teams could explore more advanced econometric methods (model-based), as long as they lead to economically meaningful weights.

    - **Data-based weights**. Under this method, weights would be determined by the economic size of the respective balance of payments vulnerability relative to the overall size of the economy. For instance, if the vulnerability is exports to a particular market, the long-term average size of those exports would be calculated as a share of the country's output.

    - **Model-based weights**. As an example of this method, vector autoregressions could be used to estimate the importance of each of the risks on observed balance of payment pressures (see Box 1 for an illustration of the use of model-based weights).

13. To demonstrate the possible estimation of external stress indices, staff constructed illustrative indices for current FCL users. These indices bring together selected sources of external risk facing these countries. They measure whether a country's external environment is better or worse than normal since each index uses differences of the proxy variables from long-run means.[6]

14. Table 2 reports the key risks, proxy variables and weights identified through the two approaches proposed above. While the individual weights differ in certain cases, both weighting methods produce broadly similar overall stress indices (Figure 1). They suggest that external stress has generally declined for all three FCL users since the first FCL arrangement requests, with stress temporarily worsening in the summer of 2013 as portfolio flows retreated from several emerging markets. The measured external stress in Poland seems to have remained higher than for Mexico and Colombia due to its exposure to the Eurozone.

[6] To make the deviations from averages comparable across proxy variables and therefore additive in a weighted average, the index also divides the differences by the long-run standard deviation of the respective proxy variables.

Box 1. An Illustrative Estimation of External Economic Stress Index Weights

The empirical method for calculating the stress index weights could employ structural Bayesian vector autoregression (BVAR) estimation. This technique detects the actual historical relation of a country's balance of payments pressures to external proxy variables, controlling for variation in the domestic economy.

The **BVAR approach** uses the same external proxy variables that correspond to vulnerabilities identified by staff as those employed in the data-based weights described in the main text. BVAR is a technique that relates a vector of macroeconomic variables to its past realizations. In this application, that vector is comprised of the external proxy variables (as described in Table 1), domestic control variables (in this case GDP growth and short-term money market interest rates) and a variable—the quarterly average exchange market pressure (EMP) index—representing the balance of payments pressures facing the country. The **external variables** used for the three current FCL countries are as follows:

- ***Poland***. Seasonally adjusted Eurozone quarter-on-quarter real output growth, the quarterly change in the US Treasury 10-year yield, the logarithm of the quarterly average value of the Euro Stoxx Banks index, and the quarterly average value of the VXEEM index.[1]
- ***Mexico and Colombia***. Seasonally adjusted US quarter-on-quarter real output growth, change in quarterly average oil price, the quarterly change in the US Treasury 10-year yield, and the quarterly average value of the VXEEM index.

The structural BVAR employs the Cholesky scheme to **identify the structural impulses** driving external developments in the model. This approach requires an ordering of variables in the BVAR vector such that each variable only impacts contemporaneously the variables that follow it in the ordering. Specifically, the ordering of external variables is the same as outlined in the bullets above and such that external trading partner growth is the most exogenous, followed by commodity prices and foreign interest rates. These variables are followed by the domestic variables, i.e. output growth, interest rate and EMP. The model applies a shrinking parameter to the latter group such that domestic variables do not influence the external proxy variables. The models are estimated using data from 1995 (or the earliest available) with 2 lags. BVAR uses priors regarding means and standard deviations on the constant term as well as the first order autocorrelation[2], which improves the efficiency of the estimation. Results are qualitatively robust to alternate ordering of external variables and lag length.

One of the outputs of the BVAR is a set of **impulse response functions**. These depict the response in each variable's values over time to a one standard deviation shock to one of the variables. Each of these functions was surveyed in the three models for the FCL countries to ensure that the model produced sensible results for all of the vector components.

The set of impulse responses of EMP to the external proxy variables is then used to **calculate the external economic stress index weights**. In particular, the absolute cumulative response over a year of exchange market pressure to each of the external risk proxies is used to weight the relative importance of each risk. In other words, the larger the impact on EMP (and therefore BoP pressures) of a shock in a particular proxy variable, the larger its weight in the index.

[1]Since VXEEM values are only available starting in 2011, prior to that VIX values are used instead, with an additional spread calculated as the average spread between VIX and VXEEM in 2011-2013.

[2]The priors are based on historical means, variances and autocorrelations over the estimation period.

Table 2. External Economic Stress Index Components

Mexico

External risk	External proxy variable	Data-based weights	Model-based weights
Exports to the US FDI from the US Remittances from the US	US growth	0.43	0.23
Oil exports	Change in oil price	0.06	0.32
Equity portfolio investment stock	Emerging market implied volatility (VXEEM)	-0.24	-0.30
Debt portfolio investment stock	Change in US Treasury 10 year yield	-0.27	-0.15

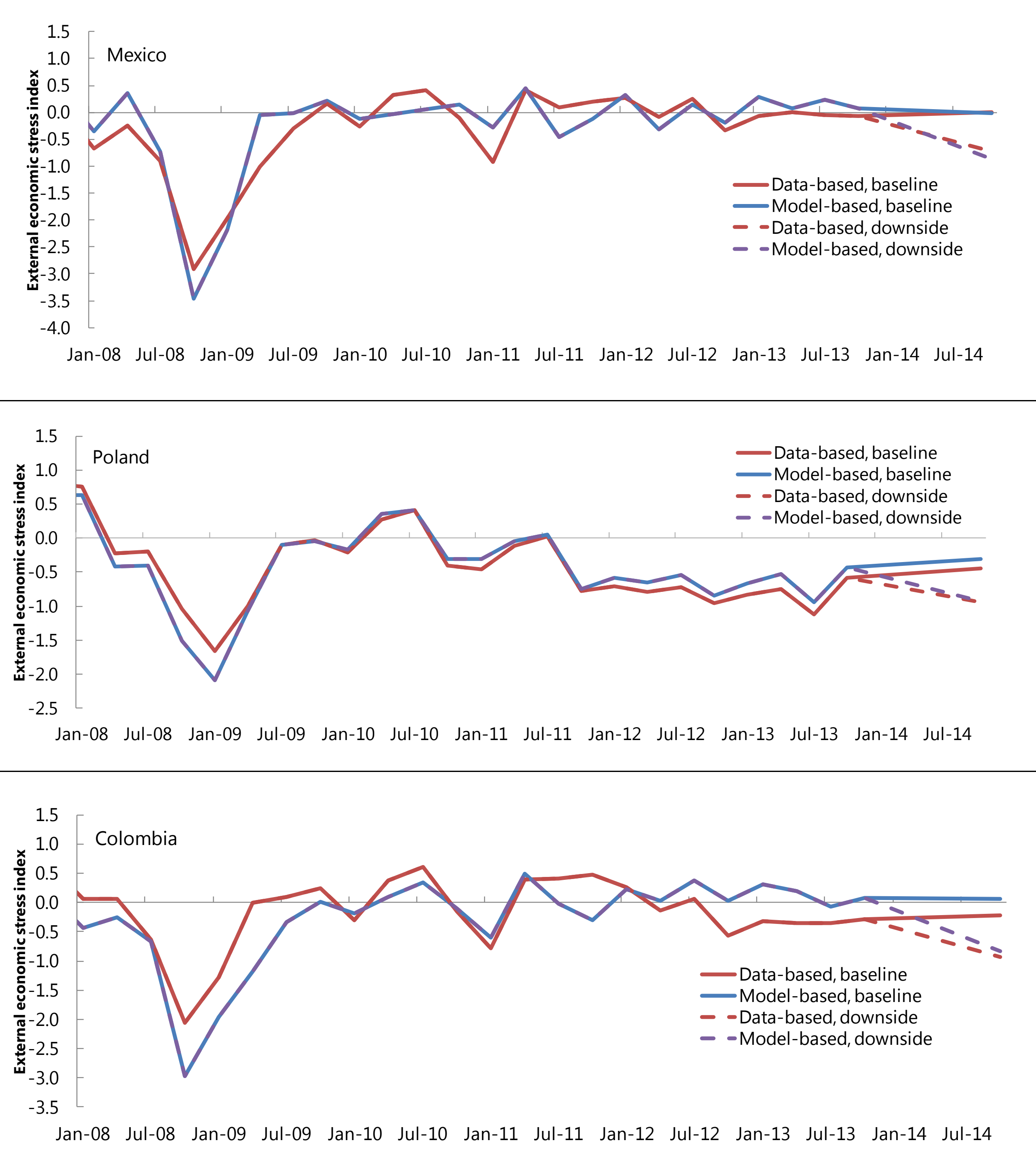
Poland

External risk	External proxy variable	Data-based weights	Model-based weights
Exports to the Eurozone FDI from the Eurozone	Eurozone growth	0.21	0.29
Stock of cross country bank exposures	European bank equity price (Euro Stoxx Banks)	0.38	0.27
Equity portfolio investment stock	Emerging market implied volatility (VXEEM)	-0.09	-0.14
Debt portfolio investment stock	Change in US Treasury 10 year yield	-0.31	-0.30

Colombia

External risk	External proxy variable	Data-based weights	Model-based weights
Oil exports Coal exports FDI into the oil industry	Change in oil price	0.32	0.03
Exports to the US	US growth	0.24	0.25
Equity portfolio investment stock	Emerging market implied volatility (VXEEM)	-0.04	-0.44
Debt portfolio investment stock	Change in US Treasury 10 year yield	-0.40	-0.28

Figure 1. Mexico, Poland, Colombia. External Economic Stress Index, 2008-2013



15. The assessment of external risks would need to capture both recent changes in the external environment and also be forward looking. The downside risk scenario would be modeled by country teams with relevant input from country authorities, drawing where appropriate on the WEO downside or G-RAM scenarios. The selected scenario should be fully justified and explained in the related staff reports. Figure 1 presents, as an example, illustrative downside risks for the three FCL users.

16. Staff proposes that the external stress index, as constructed by country teams, would be included in staff reports issued to the Board for FCL or PLL arrangements. This index is expected to provide a useful summary statistic of the external environment, including its change over time and a rough assessment of possible downside risks. It would be included in the staff report requesting an FCL or a PLL arrangement and would be updated at subsequent reviews and successor arrangements, helping to inform staff and the Board of the direction and intensity of external risks. As in the past, access and exit discussions will continue to reflect broader considerations. Taken together, this information would provide a richer backdrop for the Board to discuss access and exit.

INDICATORS OF INSTITUTIONAL STRENGTH

17. Indicators of institutional strength can play an important role in informing assessments of countries' capacity to respond appropriately in the event of a shock. Under the qualification frameworks for the FCL and the PLL, an eligible member should be assessed to have a very strong or sound institutional policy framework respectively, even though there is no separate specific qualification criterion or qualification area of institutional strength. The importance of institutional quality has been underscored by Directors on several occasions, including recently at the discussion of the Ex-post Evaluation of the FYR Macedonia PCL/PLL arrangement.[7] The FCL and the PLL operational guidance notes suggest possible indicators of institutional strength.[8] However, as some of these may be infrequently updated and not be available at the time of a specific request, most Directors were open to developing selected indicators of institutional strength during the February Board meeting. These would

[7] "A number of Directors noted that fiscal institutional weaknesses became apparent after the arrangement's approval … Directors generally saw merit in flagging domestic risks even in programs designed to insure only against external shocks. Overall, Directors agreed that the experience has underlined the importance of maintaining sound policies, strong institutions, and governance" (Press Release No. 14/69).

[8] Examples of indicators in the **fiscal policy area** include assessments of medium term plans anchoring fiscal policy outcomes and having a sound institutional budgetary framework as informed by a recent fiscal ROSC. In the **financial area** examples include assessments of the supervisory standards and practices based on FSAP findings, as well as of the legal and institutional framework and operational capacity for prompt corrective actions and emergency liquidity assistance. In the **monetary policy area**, the indicators are of the accountability, transparency and communication regarding policy objectives and policy responses.

aim to complement existing indicators to better inform qualification assessments, although judgment should continue to play a central role in these assessments.

18. Any new indicator would need to provide sufficient information regarding the strength of a member's institutions. However, while there is strong empirical evidence that institutions matter and the quality of institutions can affect macroeconomic outcomes,[9] no single indicator currently exists that can sufficiently summarize information about the quality of a country's institutional policy frameworks. In light of this, staff looked at indicators associated with the presence of sound policies and fundamentals and policymakers' ability to respond appropriately to shocks, which are important characteristics of countries eligible to use the FCL and PLL instruments. In this respect, staff drew on measures identified in the literature as well as on broader institutional measures developed by the World Bank and the International Country Risk Group (ICRG).

- **Policy cyclicality**. Institutional quality has been found to play a key role in countries' ability to implement countercyclical macroeconomic policies. Countries with strong institutions have been able to implement counter-cyclical monetary and fiscal policies, and pro-cyclicality has typically been found to be the norm in countries with weak institutions. Pro-cyclical policies, such as increasing the budget deficit (through cutting taxes and raising spending) and relaxing monetary policy during booms amplify the business cycle and generally lead to larger contractions during recessions. As such, they signal insufficiently strong policy frameworks for qualification under the FCL or PLL. While the inability to adopt counter-cyclical policies can be attributed to factors such as external borrowing constraints and underdeveloped domestic financial markets, the literature also argues that differences in the cyclical stance of macroeconomic policies can be explained by differences in institutional quality.[10, 11] In line with this, the counter-cyclicality of fiscal and monetary policy is proposed to be used as one proxy for institutional quality and is approximated by the moving correlation between the cyclically-adjusted policy variable and cyclically-adjusted GDP (Box 2).

[9] D. Acemoglu and J. Robinson, March 20, 2012, "Why Nations Fail: The Origins of Power, Prosperity, and Poverty," Crown Business; 1 edition and J.A Frankel, C.A. Vegh, and G. Vuletin, 2012, "On Graduation from Fiscal Procyclicality."

[10] C. Calderon, R. Duncan, and K. Schmidt-Hebbel, 2012, "Do Good Institutions Promote Counter-Cyclical Macroeconomic Policies?"

[11] In more rigid exchange rate regimes, the policy rate is often used pro-cyclically to defend the exchange rate level, and in these countries this particular measure of countercyclical monetary policy may not be an accurate indicator of institutional strength.

Box 2. Proposed Indicators for Assessing Institutional Quality

This box provides information on the calculation of indicators that can be used to measure counter-cyclical macroeconomic policies and the sources of institutional indicators.

Fiscal policy cyclicality. There are a number of approaches that have been employed for assessing the cyclicality of fiscal policy. However, all the various measures tend to look at the fiscal balance or government spending adjusted for the economic cycle.[1] The fiscal policy measure used in this paper is the 10-year backward correlation between the cyclical component of real GDP and the cyclical component of the ratio of government spending to GDP.[2]

Monetary policy cyclicality. There are fewer measures of monetary policy cyclicality in the literature. The indicator used in this paper is the 10-year backward correlation between the cyclical component of real GDP and the cyclical component of the real short-term interest rate, where the latter is taken as a proxy for the stance of monetary policy.[3] This measure fits well recent trends in EM monetary policy, and correlates strongly with more sophisticated estimates of Taylor coefficients on the output gap.

Fiscal rules. These rules are defined as longer-lasting constraints on fiscal policy through numerical limits on budgetary aggregates. They can be applied as expenditure, revenue, and budget balance or debt rules. The measure used in this paper is available from the IMF Fiscal Rules Dataset (2013).[4] This dataset also includes detailed information on the type of rule, enforcement, coverage and legal basis.

The International Country Risk Guide (ICRG) produces subjective assessments based on a pre-specified set of risk components. These numerical scores are available from 1985 for a broad set of countries and are updated monthly, making them a timely source of information. The indicators used are defined as:

- *Bureaucratic quality*: Whether the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services.
- *Corruption*: An assessment of corruption within the political system.

The World Bank governance indicators are composite measures which draw on a wide range of underlying sources and can be useful as a first tool for broad cross-country comparisons and for evaluating broad trends over time.

- *Government Effectiveness*: A measure capturing perceptions of the quality of public services, the quality of the civil service and whether a change in government will entail major policy disruption, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
- *Control of Corruption*: A measure capturing perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

[1] A. Fedelino, A. Ivanova, and M. Horton, 2009, "Computing Cyclically Adjusted Balances and Automatic Stabilizers," IMF Technical Notes and Manuals.
[2] See also J.A Frankel, C.A. Vegh, and G. Vuletin, 2012, "On Graduation from Fiscal Procyclicality," Forthcoming Journal of Development Economics.
[3] D. McGettigan and others, 2013 "Monetary Policy in Emerging Markets: Taming the Cycle", IMF Working Paper.
[4] A. Schaechter and others, 2012 "Fiscal Rules in Response to the Crisis- Towards the 'Next-Generation' Rules. A New Dataset," IMF Working Paper.

- **Effective response to shocks**. Strong leadership is typically required for fiscal discipline during normal times and an effective response in the event of a shock, but institutional arrangements have been found to play an important supportive role. As the ability to respond effectively to potential shocks (noted in the FCL and PLL frameworks) is unobservable, this is approximated by countries' ability to undertake large fiscal adjustment. While FCL and PLL qualifying countries are not expected to have sizable fiscal consolidation needs, institutional indicators empirically associated with large fiscal adjustment would arguably be strongly correlated with, if not the same as, the (unobservable) factors determining a country's ability to effectively respond to shocks.

19. An econometric analysis was used to identify indicators related to the ability to undertake large fiscal adjustments. Episodes of large fiscal adjustment were drawn from a 2010 Fund paper which identified 33 cases.[12] Controls were included for external macroeconomic events, the initial level of per capita GDP, and the initial level of debt—as countries with higher debt levels are more likely to face fiscal pressures. The key institutional explanatory variables used include policy anchors, such as fiscal rules (based on the work cited in footnote 8), and institutional conditions related to the quality of the bureaucracy and indicators of good governance, such as the ICRG's measures of bureaucratic quality, corruption, and law and order (i.e. rule of law). Under various specifications, the results show a very strong and positive result for both the implementation of a fiscal rule and good governance (specifically anti-corruption). These coefficients are also large enough to be economically significant, with the presence of a fiscal rule increasing the probability of undertaking a fiscal adjustment by around 10 percentage points, and a one standard deviation worsening in governance leading to a decrease by around 7 percentage points (evaluated at the mean). The quality of bureaucracy also interacts strongly with the presence of a fiscal rule, which suggests the marginal effect of adoption of a fiscal rule increases with the quality of the bureaucracy.

Determinants of Large Fiscal Adjustments

	[1] Logit - FE	[2] Logit - RE	[3] Logit - RE	[4] Logit - RE
Anti-corruption	0.66***	0.62***	0.71***	0.72***
	(0.22)	(0.21)	(0.23)	(0.23)
Fiscal rule	2.18***	2.25***	-3.45	-3.20
	(0.77)	(0.72)	(2.46)	(2.39)
Bureaucratic quality	-0.39**	-0.36**	-0.46***	-0.44***
	(0.16)	(0.15)	(0.16)	(0.15)
Bureaucratic quality*Fiscal rule			0.81**	0.78**
			(0.33)	(0.33)
Law and order	0.18	0.02	0.09	
	(0.19)	(0.18)	(0.19)	
Public debt (t-1)	0.02**	0.02**	0.02**	0.02**
	(0.01)	(0.01)	(0.01)	(0.01)
GDP per capita (t-1)	0.01	0.01	0.01	0.01
	(0.01)	(0.01)	(0.01)	(0.01)

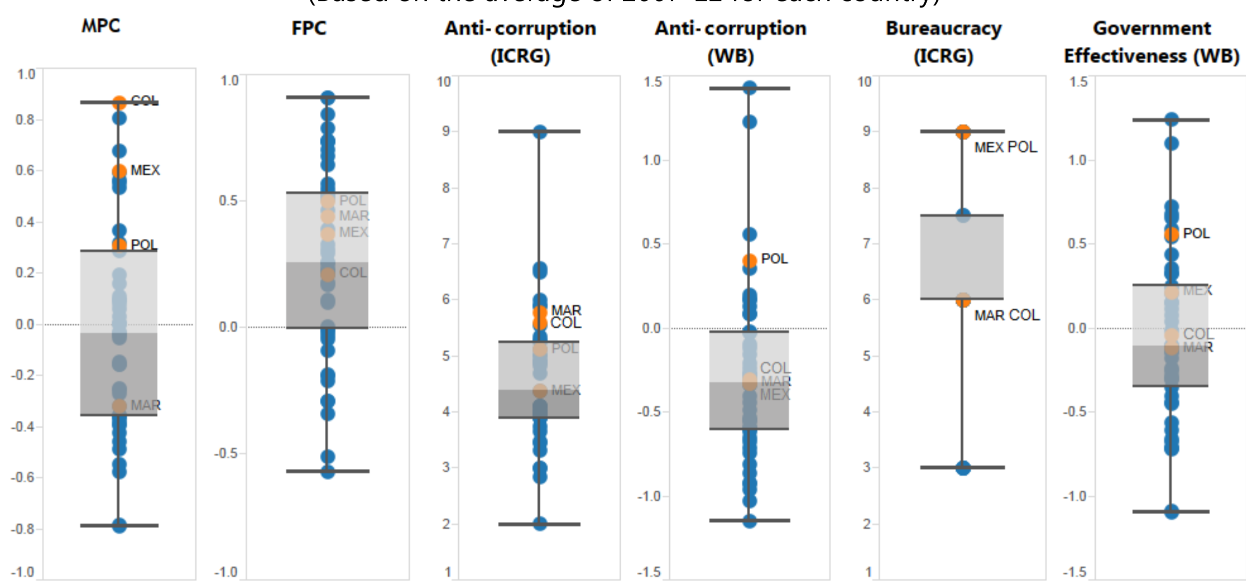
Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

[12] See "Strategies for Fiscal Consolidation in the Post-Crisis World", IMF Departmental Paper No.10/4, 2010.

20. Current FCL and PLL users score well on these indicators. Figure 2 shows the distribution of the various indicators and the relevant position of the FCL and PLL users within the distribution. The indicators used are the two measures of macroeconomic cyclicality, monetary policy cyclicality (MPC) and fiscal policy cyclicality (FPC); the two ICRG indicators that were significant in the estimated regressions, "anti-corruption" and "bureaucratic quality"; and two measures produced by the World Bank that usefully complement the ICRG indicators, "government effectiveness" and the "control of corruption". A higher score in each case indicates either better (more counter-cyclical) macroeconomic policy or stronger institutional quality. Poland scores strongly across all five indicators. Mexico and Colombia also score well but Mexico has somewhat lower scores for corruption, and Morocco scores noticeably lower in bureaucratic quality and the implementation of monetary policy (but generally still in the upper half of the distribution).[13] Although not shown here, all three FCL counties also have a fiscal rule in place. Mexico adopted a budget balance rule in 2006, Colombia had an expenditure rule in place since 2000 and a budget balance rule since 2011, and Poland has had a debt rule since 1999, a budget balance rule since 2004, and an expenditure rule since 2011.

Figure 2. The Distribution of Institutional Indicators Across Countries

(Based on the average of 2007-12 for each country)



Note: The bars represent the maximum, 75th percentile, median, 25th percentile, and minimum points in the distribution. The dots show the dispersion of the observations. The median and 25th percentile of the ICRG bureaucracy indicator are both 6.

Source: International Country Risk Guide (ICRG), WEO, WB WGI and IMF Staff Calculations.

[13] Morocco's lower score on MCP partially reflects its choice of exchange rate regime (see also footnote 11).

21. To inform the qualification process, staff proposes that the indicators highlighted in the preceding paragraph be used by staff to complement existing quantitative indicators of institutional strength already identified in the FCL and PLL guidance notes.[*] The proposed indicators could be used to inform the relative position of a country amongst its peers and would encourage a discussion in the qualification process of the extent to which a country's institutions are of an adequate quality. In this regard, these indicators would not constitute another new criterion, but would be an additional aid to judgment made by Fund staff when assessing the requirement for very strong or sound institutional policy frameworks for the FCL and PLL respectively.

IMPLEMENTATION ISSUES

22. If endorsed by the Board, the proposed changes to the qualification framework for the PLL and the bank solvency criterion for the FCL/PLL would become effective immediately for new arrangements (see ¶ 23). Regarding the external stress index and the indicators of institutional strength, staff recommends that changes endorsed by the Board will begin to be used from September 1, 2014, to allow staff sufficient time to implement the proposals. The use of these indicators will be reviewed at the time of the next review of the FCL and the PLL to take stock of experience and consider any operational issues that may have arisen.

ISSUES FOR DISCUSSION

23. This paper has provided specific proposals on the three issues that arose during the February discussions of the Review of the FCL, the PLL, and the RFI, as requested at the time of the February Board meeting. In line with these, the paper proposes the amendment of the FCL decision (Proposed Decision I) to amend the qualification criterion on bank solvency. It is also proposed to amend the PLL decision (Proposed Decision II) in order to implement the alignment of the qualification criteria for the FCL and the PLL for the purpose of qualification assessment, while maintaining the current separate qualification standards of these two instruments (Annex I). Changes to the qualification criteria for the FCL (the bank solvency criterion) and the PLL (the alignment of criteria with the FCL) will be effective immediately after the adoption of the amendments to the FCL and PLL decisions for requests for new arrangements. However, the existing FCL and PLL arrangements would be grandfathered, such that reviews under the existing arrangements will continue to be based on the qualification criteria in place at the time of approval of such arrangements. Redlined versions of the FCL, PLL, and RFI decisions are found in the Attachment. Proposed Decision III would complete the

[*] Reflecting the concern of a number of Directors about the appropriateness of relying on the indicators developed by the International Country Risk Guide, and following further discussion, Directors agreed not to endorse the International Country Risk Guide indicators (see Annex I and Revised Annex I).

review of the FCL and PCL decisions called for under Decision No. 15019-(11/112), which was adopted when the FCL was last reviewed and the PLL was created, and the review of the RFI decision. Proposed Decision IV would establish the conditions for the next reviews of the FCL decision, the PLL decision and the RFI decision. As discussed in the February meeting, staff will take stock of experience with the use of the FCL, the PLL and the RFI in three years' time, or sooner if necessary, at which point the need for a comprehensive review of the FCL and PLL as well as the RFI, will be assessed. [14]

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

- Do Directors agree with the approach proposed for unifying the FCL and PLL qualification criteria while maintaining the current standard for each instrument?
- Do Directors see merit in strengthening the bank solvency criterion? Do Directors agree with staff's proposal, as set out in this paper?
- Do Directors consider that an external stress index, along the lines discussed in this paper, would help access and exit discussions and should be presented in staff reports for new FCL and PLL arrangements and in the reports for the subsequent reviews under these arrangements?
- Do Directors see that the proposed indicators of macroeconomic policy cyclicality and institutional quality can usefully complement existing indicators and help judgments on the strength of institutional policy frameworks?
- Do Directors agree with the approach of implementing the proposals on external stress index and indicators of institutional strength to be effective as of September 1, 2014?

[14] Press Release No. 14/84 ("Directors will take stock in three years' time, or sooner if necessary, of experience with the use of the FCL, PLL, and RFI, and assess the need for a comprehensive review of each of these instruments, including a review of commitment fees, at that time.").

Proposed Decisions

Accordingly, the following decisions, each of which may be adopted by a majority of the votes cast, are proposed for adoption by the Executive Board:

I. Flexible Credit Line (FCL) Arrangements

The decision on Flexible Credit Line Arrangements, Decision No. 14283-(09/29), adopted March 24, 2009, as amended by Decision No. 14714-(10/83), adopted August 30, 2010, shall be amended as follows:

Paragraph 2 shall be amended to replace qualification criterion (vii), which currently reads "the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis", with "sound financial system and the absence of solvency problems that may threaten systemic stability, or, for arrangements approved before [date of the adoption of this decision], the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis".

II. Precautionary and Liquidity Line (PLL) Arrangements

The decision on Precautionary and Liquidity Line (PLL) Arrangements, Decision No. 15017-(11/112), adopted November 21, 2011, shall be amended as follows:

1. Paragraph 2(b) shall be renumbered as paragraph 2(b)(i).

2. Paragraph 2(b)(ii) shall be added as follows:

"With respect to arrangements to be approved after [date of the adoption of this decision], in assessing these five qualification areas specified in paragraph 2(b)(i), the Fund will in particular take into account the following nine criteria: (1) a sustainable external position; (2) a capital account position dominated by private flows; (3) a track record of steady sovereign access to international capital markets at favorable terms; (4) a reserve position that is relatively comfortable when the

PLL is requested on a precautionary basis; (5) sound public finances, including a sustainable public debt position; (6) low and stable inflation, in the context of a sound monetary and exchange rate policy framework; (7) sound financial system and the absence of solvency problems that may threaten systemic stability; (8) effective financial sector supervision; and (9) data transparency and integrity. These nine criteria are specifically linked to the five qualification areas specified in paragraph 2(b)(i) as follows: (i) external position and market access, linked to qualification criteria (1)-(4); (ii) fiscal policy, linked to qualification criterion (5); (iii) monetary policy, linked to qualification criterion (6); (iv) financial sector soundness and supervision, linked to qualification criteria (7)-(8); and (v) data adequacy, linked to qualification criterion (9).

III. Completion of Review of Decisions on FCL Arrangements, PLL Arrangements, and the RFI

1. Pursuant to Decision No. 15019-(11/112), adopted November 21, 2011, the Fund has reviewed the decision on Flexible Credit Line Arrangements, Decision No. 14283-(09/29), adopted March 24, 2009, as amended, and on Precautionary and Liquidity Line Arrangements, Decision No. 15017-(11/112), adopted November 21, 2011.

2. The Fund has reviewed the decision on the Rapid Financing Instrument (RFI), Decision No. 15015-(11/112), adopted November 21, 2011, pursuant to paragraph 7 of that decision.

3. The decision on the RFI, Decision No. 15015-(11/112), adopted November 21, 2011, shall be amended as follows:

Paragraph 7 shall be deleted and paragraph 8 shall be renumbered as paragraph 7.

IV. Review of Decisions on FCL Arrangements, PLL Arrangements and the RFI

1. It is expected that the experience with the use of the Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument will be considered no later than three years after the date of the adoption of this Decision with a view to assessing the need for a comprehensive review of each of these instruments, including a review of commitment fees.

2. Notwithstanding Paragraph 1 above, the decision on Flexible Credit Line Arrangements, Decision No. 14283-(09/29), adopted March 24, 2009, as amended, and the decision on Precautionary and Liquidity Line Arrangements, Decision No. 15017-(11/112), adopted November 21, 2011, will be reviewed jointly by the Fund whenever aggregate outstanding credit and commitments under these two Decisions reach SDR 150 billion.

Attachments–Proposed Decision–Redlined Versions

Flexible Credit Line (FCL) Arrangements –Redlined Version

1. The Fund decides that resources in the credit tranches may be made available under a Flexible Credit Line (FCL) arrangement, in accordance with the terms and conditions specified in this Decision.

2. An FCL arrangement shall be approved upon request in cases where the Fund assesses that the member (a) has very strong economic fundamentals and institutional policy frameworks, (b) is implementing—and has a sustained track record of implementing—very strong policies, and (c) remains committed to maintaining such policies in the future, all of which give confidence that the member will respond appropriately to the balance of payments difficulties that it is encountering or could encounter. In addition to a very positive assessment of the member's policies by the Executive Board in the context of the most recent Article IV consultations, the relevant criteria for the purposes of assessing qualification for an FCL arrangement shall include: (i) a sustainable external position; (ii) a capital account position dominated by private flows; (iii) a track record of steady sovereign access to international capital markets at favorable terms; (iv) a reserve position that is relatively comfortable when the FCL is requested on a precautionary basis; (v) sound public finances, including a sustainable public debt position; (vi) low and stable inflation, in the context of a sound monetary and exchange rate policy framework; (vii) sound financial system and the absence of solvency problems that may threaten systemic stability, or, for arrangements approved before [date of the adoption of the Proposed Decision I], the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis; (viii) effective financial sector supervision; and (ix) data transparency and integrity.

3. In light of the qualification criteria set out in paragraph 2 of this Decision, and except for the review requirement specified in paragraph 5 of this Decision, FCL arrangements shall not be subject to performance criteria or other forms of ex-post program monitoring.

4. There shall be no phasing under FCL arrangements and, accordingly, the entire amount of approved access will be available to the member upon approval of an FCL arrangement. A member may make one or more purchases up to the amount of approved access at any time during the period of the FCL arrangement, subject to the provisions of this Decision. The Fund shall not challenge a representation of need by a member for a purchase requested under an FCL arrangement.

5. (a) The Fund may approve a member's request for an FCL arrangement of either one year or two years duration. For FCL arrangements with a two-year duration, no purchase shall be made after one year has elapsed from the date of the approval of the FCL arrangement until an Executive Board review of the member's policies has been completed. Such a review will assess the member's continued adherence to the qualification criteria specified in paragraph 2 of this Decision, and would be scheduled with the objective of completion by the Executive Board immediately prior to the lapse of the one- year period referred to above.

(b) An FCL arrangement will expire upon the earlier of: (i) the expiration of the approved term of the arrangement; (ii) the purchase by a member of the entire amount of approved access under the FCL arrangement; or (iii) the cancellation of the FCL arrangement by the member. Upon expiration of an FCL arrangement, the Fund may approve additional FCL arrangements for the member in accordance with the terms of this Decision.

6. (a) The following procedures and arrangements for consultations with the Executive Board will apply following a member's expression of interest in an FCL arrangement:

(i) Staff will conduct a confidential preliminary assessment of the qualification criteria set forth in paragraph 2.

(ii) Where support from other creditors is likely to be important in helping a member address its balance of payments difficulties, staff will consult with key creditors as appropriate.

(iii) Once management decides that access to Fund resources under this Decision may be appropriate, it will consult with the Executive Board promptly in an informal meeting. For this purpose, Executive Directors will be provided with a concise staff note setting out the basis on which approval could be recommended under this Decision, including (I) a rigorous assessment of the member's actual or potential need for Fund resources and repayment capacity, and (II) an assessment of the impact of the arrangement on Fund liquidity in cases where it is contemplated that access would exceed 1000 percent of quota or SDR 10 billion, whichever is lower.

(iv) When the Managing Director is prepared to recommend approval of an FCL arrangement, the relevant documents, including (I) a written communication from the member requesting an FCL arrangement and outlining its policy goals and strategies for at least the duration of the arrangement as well as its commitment, whenever relevant, to take adequate corrective measures to deal with shocks that have arisen or that may arise, and (II) a staff report that assesses the member's qualification for financial assistance under the terms of this Decision, will be circulated to the Board. An assessment of the impact of the proposed FCL arrangement on the Fund's finances and liquidity position will be included in the staff report.

(v) The minimum periods applicable to the circulation of staff reports to the Executive Board shall apply to requests under this Decision, provided that the Executive Board will generally be prepared to consider a request within 48 to 72 hours after the circulation of the documentation in exceptional circumstances, such as an urgent actual balance of payments need.

(b) A member requesting an FCL arrangement would not be subject to the Fund's policy on safeguards assessments for Fund arrangements. However, at the time of making a formal written request for an FCL arrangement, such a member requesting an FCL arrangement will provide authorization for Fund staff to have access to the most recently completed annual independent audit of its central bank's financial statements, whether or not the audit is published. This will include authorizing its central bank authorities and the central bank's external auditors to discuss the audit findings with Fund staff, including any written observations by the external auditors regarding weaknesses observed in internal controls. The member will be expected to act in a cooperative manner during such discussions with the staff. For as long as Fund credit is outstanding under this Decision, the member will also provide staff with copies of annual audited financial statements and management letters, together with an authorization to discuss audit findings with the external auditor.

7. The Emergency Financing Mechanism (EFM) procedures set forth in BUFF/95/102, 9/21/1995 shall not apply to requests for FCL arrangements.

8. In order to carry out the purposes of this Decision, the Fund will be prepared to grant a waiver of the limitation of 200 percent of quota in Article V, Section 3(b)(iii), whenever necessary to permit purchases under this Decision or to permit other purchases that would raise the Fund's holdings of the purchasing member's currency above that limitation because of purchases outstanding under this Decision.

9. Paragraph 1 of Decision No. 12865-(02/102), adopted September 25, 2002, shall be deleted, and Paragraph 2, 3 and 4 of the Decision shall be renumbered as Paragraph 1, 2 and 3, respectively.

Precautionary and Liquidity Line (PLL) Arrangements—Redlined Version

1. The Fund decides that resources in the credit tranches may be made available under a Precautionary and Liquidity Line (PLL) arrangement, in accordance with the terms and conditions specified in this Decision.

2. (a) A PLL arrangement shall be approved upon request in cases where the Fund assesses that the member (i) has sound economic fundamentals and institutional policy frameworks, (ii) is implementing-and has a track record of implementing-sound policies, and (iii) remains committed to maintaining such policies in the future, all of which give confidence that the member will take the policy measures needed to reduce any remaining vulnerabilities and will respond appropriately to the balance of payments difficulties that it is encountering or might encounter.

(b) (i) In addition to requiring a generally positive assessment of the member's policies by the Executive Board in the context of the most recent Article IV consultations, a member's qualification for a PLL arrangement shall be assessed in the following areas (with the member being expected to perform strongly in most of these areas and not to substantially underperform in any of them): (i) external position and market access, (ii) fiscal policy, (iii) monetary policy, (iv) financial sector soundness and supervision, and (v) data adequacy.

(ii) With respect to arrangements to be approved after [date of the adoption of the Proposed Decision II], in assessing these five qualification areas specified in paragraph 2(b)(i), the Fund will in particular take into account the following nine criteria: (1) a sustainable external position; (2) a capital account position dominated by private flows; (3) a track record of steady sovereign access to international capital markets at favorable terms; (4) a reserve position that is relatively comfortable when the PLL is requested on a precautionary basis; (5) sound public finances, including a sustainable public debt position; (6) low and stable inflation, in the context of a sound monetary and exchange rate policy framework; (7) sound financial system and the absence of solvency problems that may threaten systemic stability; (8) effective financial sector supervision; and (9) data transparency and integrity. These nine criteria are specifically linked to the five qualification areas specified in paragraph 2(b)(i) as follows: (i) external position and market access, linked to qualification criteria (1)-(4); (ii) fiscal policy, linked to qualification criterion (5); (ii) monetary policy, linked to qualification criterion (6); (iv) financial sector soundness and supervision, linked to qualification criteria (7)-(8); and (v) data adequacy, linked to qualification criterion (9).

(c) Notwithstanding paragraph 2(b) above, the Fund shall not approve a PLL arrangement for a member facing any of the following circumstances: (i) sustained inability to access international capital markets, (ii) the need to undertake a large macroeconomic or structural policy adjustment (unless such adjustment has credibly been launched before approval), (iii) a public debt position that is not sustainable in the medium term with a high probability, or (iv) widespread bank insolvencies.

3. (a) The Fund may approve a member's request for a PLL arrangement (i) with a duration of one to two years, or (ii) with a duration of six months in circumstances where the member has an actual or potential short-term balance of payments need such that it can generally be expected to make credible progress in addressing its vulnerabilities during the six-month period of the arrangement.

(b) PLL arrangements with a duration of one to two years shall have conditionality that includes indicative targets, as well as the standard performance criteria related to trade and exchange restrictions, bilateral payments arrangements, multiple currency practices and non-accumulation of external debt payments arrears as specified in paragraphs 3(d) and 3(b)(ii), respectively, of Attachment A of Decision No. 10464-(93/130), adopted September 13, 1993 as amended. The conditionality under these PLL arrangements may also include other performance criteria, prior actions and structural benchmarks where warranted under the Guidelines on Conditionality set forth in Decision No. 12864-(02/102), adopted September 25, 2002, as amended. PLL arrangements with a duration of one to two years shall provide for six-monthly reviews by the Executive Board to assess whether the member's PLL-supported program remains on track to achieve its objectives based on relevant factors such as the member's observance of performance criteria, indicative targets and structural benchmarks, as applicable; its continued adherence to the PLL qualification standard set forth in paragraphs 2(a) and 2(b) of this Decision; and its policy understandings for the future. Such reviews would be scheduled with the objective of completion by the Executive Board immediately prior to the lapse of each six-month period referred to above.

(c) The conditionality under PLL arrangements with a six-month duration shall include the standard performance criteria specified in paragraph 3(b) above and may also include prior actions where warranted under the Guidelines on Conditionality, but shall not include reviews or other forms of ex post conditionality.

4. (a) Subject to paragraphs 4(b) and 4(c) of this Decision, access to Fund resources under the PLL instrument shall be subject to a cumulative cap of 1000 percent of quota, net of scheduled repurchases, which shall apply to all PLL arrangements regardless of duration.

(b) In addition to the PLL instrument access cap specified in paragraph 4(a) above, access under PLL arrangements with a duration of one to two years shall be subject to an annual access limit of 500 percent of quota (net of scheduled repurchases) applicable at the time of approval of such arrangements, and shall be subject to the following additional considerations:

(i) For one-year PLL arrangements approved for members not having an actual balance of payment need at the time of approval of the arrangement, the entire amount of approved access shall be available upon approval of the arrangement and shall remain available throughout the arrangement period, subject to completion of a six-monthly review as specified in paragraph 3(b) of this Decision. For PLL arrangements with a duration of one to two years approved for members not having an actual balance of payment need at the time of approval of the arrangement, purchases shall be phased, with an initial amount not in excess of 500 percent of quota being available upon approval of the arrangement and the remaining amount being made available at the beginning of the second year of arrangement, subject to completion of the relevant six-monthly reviews specified in paragraph 3(b) of this Decision.

(ii) For PLL arrangements with a duration of one to two years approved for members that are facing an actual balance of payments need at the time of approval of the arrangement, purchases shall be phased, with an initial amount being available upon approval of the arrangement and the remaining amounts being made available at semi- annual intervals, subject to completion of the relevant six-monthly reviews specified in paragraph 3(b) of this Decision.

(c) In addition to the PLL instrument access cap specified in paragraph 4(a) above, the following access limits and additional considerations shall apply to six-month PLL arrangements:

(i) A per arrangement limit of 250 percent of quota, net of scheduled repurchases, shall normally apply to six-month PLL arrangements, with the entire amount of approved access being available to the member upon approval of the arrangement and remaining available throughout the arrangement period.

(ii) A per arrangement limit of 500 percent of quota, net of scheduled repurchases, shall apply to six- month PLL arrangements in exceptional circumstances where a member is experiencing or has the potential to experience short-term balance of payments needs that exceed the 250 percent of quota limit specified in paragraph 4(c)(i) above due to the impact of exogenous shocks, including heightened regional or global stress conditions. Accordingly, the Fund may in these circumstances, and on a case-by-case basis, approve a new six-month PLL arrangement or augment access under an existing six-month PLL arrangement up to this higher limit, with the entire amount of approved access being available to the member upon approval of the arrangement or, in the case of augmentations, upon completion of an ad hoc review under paragraph 4(d) below, and remaining available throughout the arrangement period.

(iii) Total access to Fund resources under all six-month PLL arrangements shall in no event exceed a cumulative six-month PLL arrangement access limit of 500 percent of quota, net of scheduled repurchases.

(d) Subject to the PLL instrument access cap specified in paragraph 4(a) above and, for six-month PLL arrangements, subject to the limits specified in paragraph 4(c) above, the Fund will stand ready to consider a member's request to make additional amounts available under any PLL arrangement. The Fund will also stand ready to rephase access under PLL arrangements with a duration of one to two years. Such augmentation or rephasing of access shall be considered in the context of a scheduled or ad hoc review in which the Fund assesses the member's actual or potential need for Fund resources and the extent to which the PLL-supported program remains on track to achieve its objectives based on the factors specified for six-monthly reviews in paragraph 3(b) of this Decision.

5. (a) A PLL arrangement will expire upon the earlier of: (i) the expiration of the approved term of the arrangement, (ii) the purchase by a member of the entire amount of approved access under the PLL arrangement, or (iii) the cancellation of the PLL arrangement by the member.

(b) Upon the expiration of a PLL arrangement, the Fund may on a case-by-case basis approve additional PLL arrangements with a duration of one to two years for the member in accordance with the terms of this Decision, including the provisions on qualification and use of prior actions where warranted.

(c) Following the expiration of a six-month PLL arrangement, the Fund may on a case-by-case basis approve additional six-month PLL arrangements for the member in accordance with the terms of this Decision, including the provisions on qualification and use of prior actions where warranted, if either (i) at least two years have elapsed since the approval of the most recent six-month PLL arrangement, or (ii) the member's balance of payments need is longer than originally anticipated due to the impact of exogenous shocks, including heightened regional or global stress conditions, provided that not more than one additional six-month PLL arrangement may be approved under the circumstances specified in this clause (ii).

6. The following procedures and arrangements for consultations with the Executive Board will apply following a member's expression of interest in any PLL arrangement:

(a) Staff will conduct a confidential preliminary assessment of the qualification criteria set forth in paragraph 2 of this Decision.

(b) Once management decides that access to Fund resources under this Decision may be appropriate, it will consult with the Executive Board promptly in an informal meeting. For this purpose, Executive Directors will be provided with a concise note setting out the basis on which approval could be recommended under this Decision, including a preliminary assessment of the member's qualification for the PLL, an initial discussion of the key policy areas where policy actions might be sought and an assessment of the member's actual or potential need for Fund resources and repayment capacity.

7. A member may make one or more purchases up to the amount available under a PLL arrangement, subject to the provisions of this Decision. The Fund shall not challenge a representation of need by a member for a purchase requested under a PLL arrangement.

8. Phasing and performance clauses shall be omitted in any PLL arrangement in the first credit tranche.

They will be included in other PLL arrangements where specified under the terms of this Decision, but will apply only to purchases outside the first credit tranche.

9. In requesting a PLL arrangement, the member shall submit a concise written communication outlining its policy goals and strategies for at least the duration of the arrangement as well as measures aimed at addressing its remaining vulnerabilities, together with a quantified macroeconomic framework. Where PLL arrangements with a duration of one to two years are requested, such a framework shall be underpinned by a streamlined set of indicative targets, and where warranted, structural benchmarks and performance criteria. For six-month PLL arrangements, the member shall commit to undergo a safeguards assessment, provide staff with access to its central bank's most recently completed external audit reports and authorize its external auditors to hold discussions with Fund staff. The timing and modalities for the safeguards assessment for members with a six-month PLL arrangement would be determined on a case-by- case basis, but normally the safeguards assessment would need to be completed before Executive Board approval for the member of any subsequent arrangement to which the Fund's safeguards assessments policy applies.

10. In order to carry out the purposes of this Decision, the Fund will be prepared to grant a waiver of the limitation of 200 percent of quota in Article V, Section 3(b)(iii), whenever necessary to permit purchases under this Decision or to permit other purchases that would raise the Fund's holdings of the purchasing member's currency above that limitation because of purchases outstanding under this Decision.

11. All arrangements under Decision No. 14715-(10/83), adopted August 30, 2010 on Precautionary Credit Line Arrangements, that are in force on the effective date of this Decision shall be renamed arrangements under the Precautionary and Liquidity Line, and shall be subject to the terms of this Decision.

12. The term "PCL" in Decision No. 14064-(08/18), adopted February 22, 2008, as amended, on access policy and limits in the credit tranches, is revised to read "PLL"; and the terms "Precautionary Credit Line" and "PCL" in Decision No. 14745-(10/96), adopted September 28, 2010 on Article IV consultation cycles, are revised to read "Precautionary and Liquidity Line" and "PLL", respectively.

13. Decision No. 7925-(85/38), adopted March 8, 1985, as amended, on the relationship between performance criteria and phasing under GRA arrangements, shall not apply to PLL arrangements.

14. Decision No. 14715-(10/83), adopted August 30, 2010 on Precautionary Credit Line Arrangements, is hereby repealed.

Rapid Financing Instrument (RFI)—Redlined Version

1. The Fund decides that resources in the credit tranches may be made available under the Rapid Financing Instrument (RFI), in accordance with the terms and conditions specified in this Decision.

2. The Fund will approve a member's request for resources under the RFI only where it is satisfied that:

(a) the member is experiencing an urgent balance of payments need that, if not addressed, would result in an immediate and severe economic disruption;

(b) the member either (i) has a balance of payments need that is expected to be resolved within one year with no major policy adjustments being necessary, or (ii) is unable to design or implement an upper credit tranche-quality economic program given the urgent nature of the balance of payments need or due to its limited policy implementation capacity; and

(c) the member will cooperate with the Fund in an effort to find, where appropriate, solutions for its balance of payments difficulties. Where warranted, the Managing Director may request that the member implement upfront measures before recommending that the Fund approve a purchase under this Decision.

3. If a member has made a purchase under this Decision within the preceding three years, any additional purchases under this Decision may be approved only if the Fund is satisfied that (a) the member's urgent balance of payments need was caused primarily by an exogenous shock; or (b) the member has established a track record of adequate macroeconomic policies over a period of at least six months immediately prior to the request.

4. A member requesting assistance under this Decision shall describe in a letter the general policies it plans to pursue to address its balance of payments difficulties, including its intention not to introduce or intensify exchange and trade restrictions and other measures or policies that would compound these difficulties. The member shall also commit to undergoing a safeguards assessment, provide staff with access to its central bank's most recently completed external audit reports and authorize its external auditors to hold discussions with Fund staff. The timing and modalities for the safeguards assessment for a member that has received assistance under the RFI would be determined on a case-by-case basis, but normally the safeguards assessment would need to be completed before Executive Board approval for the member of any subsequent arrangement to which the Fund's safeguards assessment policy applies.

5. Assistance under this Decision shall be made available to members in the form of outright purchases. Access by members to resources under this Decision shall be subject to (a) an annual limit of 50 percent of quota, and (b) a cumulative limit of 100 percent of quota, net of scheduled repurchases.

6. In order to carry out the purposes of this Decision, the Fund will be prepared to grant a waiver of the limitation of 200 percent of quota in Article V, Section 3(b)(iii), whenever necessary to permit purchases under this Decision or to permit other purchases that would raise the Fund's holdings of the purchasing member's currency above that limitation because of purchases outstanding under this Decision.

7. ~~It is expected that the Fund will review this Decision one year after the date of adoption of this Decision.~~

~~8.~~ Decision No. 12341-(00/117), adopted November 28, 2000, which established the special GRA policy on emergency assistance, is hereby repealed. (SM/11/284, Sup. 3, 11/22/11)

Decision No. 15015-(11/112),

November 21, 2011

Annex I. FCL and PLL Qualification Assessment

1. **This annex provides the key considerations for establishing the qualification framework to access financing under the FCL and PLL, with a view to promoting a predictable and evenhanded qualification process**. The qualification criteria for the FCL and PLL are drawn from those already established by the Executive Board for the Short-Term Liquidity Facility, as well as the qualification criteria discussed by the Board in the context of the Reserve Augmentation Line (RAL).[1]

2. **The core of the qualification framework for the FCL is an assessment that the members' economic fundamentals, institutional policy framework, and policies are very strong**. These qualification criteria, together with a sustained track record of very strong policy implementation, would give markets and the Fund confidence that the member would take appropriate corrective policy measures when facing an adverse shock, consistent with addressing the BOP problems it may be facing and with repaying the Fund. Member's policies must have been assessed very positively by the Executive Board in the context of the most recent Article IV consultations. As FCL resources can be used for any BOP problem and an FCL arrangement can be approved in the face of an actual or potential financing need, qualification for the FCL would not preclude circumstances where the member would need or plan to undertake policy adjustments.

3. **The core qualification for the PLL is an assessment that the member's economic fundamentals, institutional policy framework, and policies are generally sound**. Those, together with a track record of sound policy implementation, would give markets and the Fund confidence that the member will take the policy measures needed to reduce any remaining vulnerabilities and respond appropriately to any BoP problem it is encountering or might encounter, consistent with repaying the Fund. As a member qualifying under a PLL arrangement may still face remaining vulnerabilities (although not substantial) in few areas, the qualification assessment for the PLL will be a crucial tool in identifying areas for prior actions and/or ex post policy conditionality, as applicable under the PLL decision. The member's policies must have been assessed as generally positive by the Executive Board in the context of the most recent Article IV consultation.

4. **Qualifications for the FCL and PLL are based on nine specific qualification criteria as set forth below**. In respect of the PLL, the member's performance under the nine qualification criteria will be assessed based on five broad qualification areas. Any assessment of qualification involves a degree of judgment. The assessment of the qualification criteria, noted below, will need to take into account the great variety of the member's circumstances and the uncertainties that attend economic projections. For the FCL strong performance against all relevant criteria

[1] See PIN/06/104, 9/13/06 and PIN/07/40, 3/23/07.

noted below would not be necessary to secure qualification. However, significant shortcomings on one or more of these criteria—unless there are compensating factors, including corrective policy measures underway—could generally signal that the member is not among the strong performers for whom the FCL is intended. For the PLL the qualification standard is based on strong performance in most of the five qualification areas (i.e., three of five areas) noted below. Substantial underperformance in any area signals that the member does not qualify for a PLL. In addition, a member would not be qualified to use the PLL if any of the following circumstances apply: (i) sustained inability to access international capital markets, (ii) the need to undertake large macroeconomic or structural policy adjustments (unless such adjustment has already set credibly in train before approval), (iii) a public debt position that is not sustainable in the medium term with a high probability, and (iv) widespread bank insolvencies.

Qualification Criteria

5. For the FCL and PLL assessments staff would rely primarily on the following nine specific qualification criteria, which for purposes of the PLL are grouped under five broad qualification areas I-V, and set of relevant indicators that seek to establish the strength of the member's underlying fundamentals and economic policies:

I. External position and market access

- *A sustainable external position*. Relevant indicators would be: the debt-stabilizing noninterest current account balance; the level and composition of external debt; the level of net international reserves and the level and composition of private sector external assets; and assessments of exchange rate misalignment.

- *A capital account position dominated by private flows*. Relevant indicators would be an assessment of the International Investment Position and the composition of recent capital flows.

- *A track record of steady sovereign access to capital markets at favorable terms*. Relevant indicators would be a comparison of spreads with comparator countries and relative performance of spreads during periods of global shocks.

- *When the arrangement is requested on a precautionary basis, a reserve position which—notwithstanding potential BOP pressures that justify Fund assistance—remains relatively comfortable*. Assessment of reserve levels would take into account a number of metrics (imports, short-term debt, monetary base, ARA metric) as relevant given the member's exchange rate regime.

II. Fiscal policy

- *Sound public finances, including a sustainable public debt position* determined by a rigorous and systematic debt sustainability analysis. The analysis would cover the evolution of debt, as well as rollover and financing requirements under alternative scenarios (including an assessment of contingent liabilities, where appropriate) and stress tests. Relevant indicators may include the recent evolution of fiscal balances in relation to the economy's cyclical position; the quality of any adjustment measures being considered; an assessment of medium-term plans anchoring fiscal policy outcomes; the moving correlation between the cyclically-adjusted fiscal balance or government spending and cyclically-adjusted GDP, and an overall sound institutional budgetary framework as informed by recent fiscal ROSCs, where available.

III. Monetary policy

- *Low and stable inflation, in the context of a sound monetary and exchange rate policy framework*. Relevant indicators would include the recent evolution of core and headline inflation and inflation expectations; past and announced policy responses to inflationary shocks; the adequacy of monetary policy instruments to conduct monetary policy; accountability, transparency, and communication regarding policy objectives and policy responses. Relevant indicators include the moving correlation between the cyclically-adjusted real short-term policy rate and cyclically-adjusted GDP. In countries with rigid exchange rate regimes, it may also be worth exploring the cyclicality of cash reserve requirements.

IV. Financial sector soundness and supervision

- *Sound financial system and the absence of solvency problems that may threaten systemic stability.* A range of indicators and available information may be combined to assess this criterion, such as compliance with regulatory requirements, measures of profitability, and asset quality; and, where available, analyses of market, credit, and liquidity risks facing banks based on recent FSAPs or other sources.

- *Effective financial sector supervision.* Relevant modalities to establish observance with this criterion would be provided by an assessment of the supervisory framework and of the legal and institutional framework, as well as the operational capacity, to respond promptly if bank interventions and resolution is warranted and if emergency liquidity assistance is needed.

V. Data adequacy

- *Data transparency and integrity.* Subscription to the Special Data Dissemination Standard or a judgment that satisfactory progress is being made toward meeting its requirements will also be a relevant qualification criterion.

Indicators on Institutional Strength

6. Under the qualification frameworks for the FCL and the PLL, an eligible member should be assessed to have a very strong or sound institutional policy framework for the FCL and the PLL respectively. To complement the assessment of staff in this area, the following indicators could also be considered.

- *Policy cyclicality described above.*
- *Effective response to shocks*. Relevant indicators to inform this judgment include indicators on bureaucratic quality, government effectiveness, and control of corruption available from International Country Risk Guide[**] and the World Bank Governance Indicators Database.

[**] Reflecting the concern of a number of Directors about the appropriateness of relying on the indicators developed by the International Country Risk Guide, and following further discussion, Directors agreed not to endorse the International Country Risk Guide indicators (see Revised Annex I).

Revised Annex I. FCL and PLL Qualification Assessment

1. **This annex provides the key considerations for establishing the qualification framework to access financing under the FCL and PLL, with a view to promoting a predictable and evenhanded qualification process**. The qualification criteria for the FCL and PLL are drawn from those already established by the Executive Board for the Short-Term Liquidity Facility, as well as the qualification criteria discussed by the Board in the context of the Reserve Augmentation Line (RAL).[1]

2. **The core of the qualification framework for the FCL is an assessment that the members' economic fundamentals, institutional policy framework, and policies are very strong**. These qualification criteria, together with a sustained track record of very strong policy implementation, would give markets and the Fund confidence that the member would take appropriate corrective policy measures when facing an adverse shock, consistent with addressing the BOP problems it may be facing and with repaying the Fund. Member's policies must have been assessed very positively by the Executive Board in the context of the most recent Article IV consultations. As FCL resources can be used for any BOP problem and an FCL arrangement can be approved in the face of an actual or potential financing need, qualification for the FCL would not preclude circumstances where the member would need or plan to undertake policy adjustments.

3. **The core qualification for the PLL is an assessment that the member's economic fundamentals, institutional policy framework, and policies are generally sound**. Those, together with a track record of sound policy implementation, would give markets and the Fund confidence that the member will take the policy measures needed to reduce any remaining vulnerabilities and respond appropriately to any BoP problem it is encountering or might encounter, consistent with repaying the Fund. As a member qualifying under a PLL arrangement may still face remaining vulnerabilities (although not substantial) in few areas, the qualification assessment for the PLL will be a crucial tool in identifying areas for prior actions and/or ex post policy conditionality, as applicable under the PLL decision. The member's policies must have been assessed as generally positive by the Executive Board in the context of the most recent Article IV consultation.

4. **Qualifications for the FCL and PLL are based on nine specific qualification criteria as set forth below**. In respect of the PLL, the member's performance under the nine qualification criteria will be assessed based on five broad qualification areas. Any assessment of qualification involves a degree of judgment. The assessment of the qualification criteria, noted below, will need to take into account the great variety of the member's circumstances and the uncertainties that attend economic projections. For the FCL, very strong performance against all relevant

[1] See PIN/06/104, 9/13/06 and PIN/07/40, 3/23/07.

criteria noted below would not be necessary to secure qualification. However, significant shortcomings on one or more of these criteria—unless there are compensating factors, including corrective policy measures underway—could generally signal that the member is not among the very strong performers for whom the FCL is intended. For the PLL the qualification standard is based on strong performance in most of the five qualification areas (i.e., three of five areas) noted below. Substantial underperformance in any area signals that the member does not qualify for a PLL. In addition, a member would not be qualified to use the PLL if any of the following circumstances apply: (i) sustained inability to access international capital markets, (ii) the need to undertake large macroeconomic or structural policy adjustments (unless such adjustment has already set credibly in train before approval), (iii) a public debt position that is not sustainable in the medium term with a high probability, and (iv) widespread bank insolvencies.

Qualification Criteria

5. **For the FCL and PLL assessments staff would rely primarily on the following nine specific qualification criteria, which for purposes of the PLL are grouped under five broad qualification areas I-V**, and set of relevant indicators that seek to establish the strength of the member's underlying fundamentals and economic policies:

I. External position and market access

- *A sustainable external position*. Relevant indicators would be: the debt-stabilizing noninterest current account balance; the level and composition of external debt; the level of net international reserves and the level and composition of private sector external assets; and assessments of exchange rate misalignment.
- *A capital account position dominated by private flows*. Relevant indicators would be an assessment of the International Investment Position and the composition of recent capital flows.
- *A track record of steady sovereign access to capital markets at favorable terms*. Relevant indicators would be a comparison of spreads with comparator countries and relative performance of spreads during periods of global shocks.
- *When the arrangement is requested on a precautionary basis, a reserve position which—notwithstanding potential BOP pressures that justify Fund assistance—remains relatively comfortable*. Assessment of reserve levels would take into account a number of metrics (imports, short-term debt, monetary base, ARA metric) as relevant given the member's exchange rate regime.

II. Fiscal policy

- *Sound public finances, including a sustainable public debt position* determined by a rigorous and systematic debt sustainability analysis. The analysis would cover the evolution of debt, as well as rollover and financing requirements under alternative scenarios (including an assessment of contingent liabilities, where appropriate) and stress tests. Relevant indicators may include the recent evolution of fiscal balances in relation to the economy's cyclical position; the quality of any adjustment measures being considered; an assessment of medium-term plans anchoring fiscal policy outcomes; and an overall sound institutional budgetary framework as informed by recent fiscal ROSCs, where available.

III. Monetary policy

- *Low and stable inflation, in the context of a sound monetary and exchange rate policy framework*. Relevant indicators would include the recent evolution of core and headline inflation and inflation expectations; past and announced policy responses to inflationary shocks; the adequacy of monetary policy instruments to conduct monetary policy; accountability, transparency, and communication regarding policy objectives and policy responses.

IV. Financial sector soundness and supervision

- *Sound financial system and the absence of solvency problems that may threaten systemic stability.* A range of indicators and available information may be combined to assess this criterion, such as compliance with regulatory requirements, measures of profitability, and asset quality; and, where available, analyses of market, credit, and liquidity risks facing banks based on recent FSAPs or other sources.

- *Effective financial sector supervision.* Relevant modalities to establish observance with this criterion would be provided by an assessment of the supervisory framework and of the legal and institutional framework, as well as the operational capacity, to respond promptly if bank interventions and resolution is warranted and if emergency liquidity assistance is needed.

V. Data adequacy

- *Data transparency and integrity.* Subscription to the Special Data Dissemination Standard or a judgment that satisfactory progress is being made toward meeting its requirements will also be a relevant qualification criterion.

Indicators on Institutional Strength

6. **Under the qualification frameworks for the FCL and the PLL, an eligible member should be assessed to have a very strong or sound institutional policy framework for the FCL and the PLL respectively**. To complement the assessment of staff in this area, the following indicators could also be considered.

- *Policy cyclicality*. Relevant indicators to inform this judgment may include, for fiscal policy, the moving correlation between the cyclically-adjusted fiscal balance or government spending and cyclically-adjusted GDP, and for monetary policy, the moving correlation between the cyclically-adjusted real short-term policy rate and cyclically-adjusted GDP. In countries with rigid exchange rate regimes, it may also be worth exploring the cyclicality of cash reserve requirements.

- *Effective response to shocks*. Relevant indicators to inform this judgment include government effectiveness and the control of corruption from the World Bank Governance Indicators Database.