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A Critical Review of the IMF's Tools for Crisis Prevention

Roberto Marino / Ulrich Volz

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Abstract

Against the backdrop of the International Monetary Fund's (IMF) increasing focus on crisis prevention measures and the G20's discussion of "global safety nets", this paper analyses the IMF's tools for crisis prevention, with particular emphasis on the recently developed Flexible Credit Line (FCL) and Precautionary Credit Line (PCL). The paper reviews why it took the Fund so long to develop crisis prevention facilities that would find subscribers and scrutinises initial experiences with the FCL and PCL. Moreover, it discusses the systemic implications of and problems associated with such crisis prevention facilities and examines why only so few countries are using these facilities thus far. Based on this analysis, it offers policy recommendations for the development of the IMF's crisis prevention facilities.

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Abbreviations

CCL	Contingent Credit Line
CEMBI	Corporate Emerging Markets Bond Index
CMIM	Chiang Mai Initiative Multilateralisation
DDO	Deferred Drawdown Option
DPL	Development Policy Loan
EMBIG	Emerging Markets Bond Index Global
EWE	Early Warning Exercise
FCL	Flexible Credit Line
FSAP	Financial Sector Assessment Programmes
GDP	Gross domestic product
GFSR	Global Financial Stability Report
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
MAP	Mutual Assessment Process
NAB	New Arrangement to Borrow
PCL	Precautionary Credit Line
PLL	Precautionary Liquidity Line
RAL	Reserve Augmentation Line
RFA	Regional Financing Arrangement
ROSC	Reports on Observance of Standards and Codes
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Rights
SLF	Short-Term Liquidity Facility
STFF	Short-Term Financing Facility
WEO	World Economic Outlook

1 Introduction

The international financial system has been shaken by a number of crises over the last three decades. Some had a systemic dimension while others were confined to specific geographic regions or individual countries. Until the eruption of the 2008 crisis the general perception was that crises would occur mainly in developing and emerging market economies.

While the trend towards globalisation has produced many benefits, it has also meant that the world's financial system has become more complex, with a growing number of major players who are capable of placing greater stress on the system through their domestic policies. The growing interconnectedness of economies in trade and finance means that problems in one country can easily be transmitted to other countries. The cost and frequency of crises has increased. Therefore, under these circumstances it is important to improve the international toolkit for crisis prevention. The goal should be to act pre-emptively in order to ensure the implementation of policies that prevent the build-up of unsustainable imbalances and make adequate resources readily available for dealing with episodes of contagion in the financial markets.

Historically, the International Monetary Fund (IMF) has been more occupied with crisis resolution than crisis prevention. While the creation of crisis prevention facilities has been discussed since the early 1990s, it took the Fund's Executive Board until March 2009 to launch a facility – the Flexible Credit Line (FCL) – with *ex ante* conditionality for member countries with very strong economic fundamentals and institutional policy frameworks that would find subscribers. Shortly thereafter, in August 2010, the Fund launched the Precautionary Credit Line (PCL) for countries that do not qualify for the FCL due to moderate vulnerabilities in spite of sound fundamentals and policy track records. The creation of these two facilities marked a new era in the Fund's approach to crisis prevention. At the Cannes Summit in November 2011, the G20 leaders underlined their determination *"to continue [...] efforts to further strengthen global financial safety nets and [...] support the IMF in putting forward the new Precautionary and Liquidity Line (PLL) to provide on a case by case basis increased and more flexible short-term liquidity to countries with strong policies and fundamentals facing exogenous shocks"* (G20: §10). Shortly after the Cannes Summit, the IMF launched the PLL as an expansion of the PCL as a means of providing short-term liquidity support over the course of six months.

Against the backdrop of the Fund's increasing focus on crisis prevention measures and the discussion of global safety nets among the G20, the objective of this paper is to analyse the IMF's tools for crisis prevention, with a particular emphasis on recent experiences with the FCL and the PCL. The paper seeks to answer the following questions: Why did IMF crisis prevention facilities take so long to develop? What initial experience has been gathered with the FCL and PCL? What are the systemic implications of and problems associated with such crisis prevention facilities? Why are so few countries using these facilities, and how can the FCL and PLL – which has now replaced the PCL – be made more attractive?

The paper is structured as follows. The next section (Section 2) provides a brief description of the IMF's work on helping to prevent crises through its surveillance work. Section 3 then reviews the development of the Fund's crisis prevention instruments between the time of the first discussions in the Executive Board in 1993 and the creation of the FCL and PCL in 2009 and 2010, respectively. The chronology of the debate on crisis prevention facilities at the IMF highlights the many difficulties that were encountered before the creation and use of these facilities. The main creditor countries of the IMF were hesitant to create facilities that committed a large amount of resources up front without the traditional *ex post* conditionality and no phasing of the drawings. For their part, the potential users of the crisis prevention instruments were cautious about using them due to the stigma attached to the use of traditional IMF facilities. In general, potential users had relatively comfortable access to financial markets until 2008 and did not believe that the design of the instruments offered by the IMF at the time matched the features that they required from a crisis prevention, insurance-type, instrument. The 2008 financial crisis can be considered as the turning point in the debate for the creation of crisis prevention instruments in light of the need to use the entire available arsenal to halt contagion and create conditions for emerging from the crisis coupled with the need of certain countries for this type of instrument.

Section 4 takes stock of initial experiences with the FCL and PCL. The motivation of Mexico, Colombia and Poland – the first three countries to seek an FCL arrangement – for using the FCL is analysed, as well as the immediate impact of the FCL on their macroeconomic and financial variables. We conclude that the FCL has been a very successful instrument from the view point of the three pioneer countries, since they have on two occasions renewed the FCL (with the most recent renewal spanning a two-year period), and that the FCL has helped to fortify their reserve position and creditworthiness. We also put emphasis on the benefits of the FCL for the IMF as an instrument that strengthens its surveillance practices, generates positive externalities in terms of a healthier world economy, and contributes to its finances. Although experiences gathered to date with the PCL are too recent for forming a comprehensive judgement, the fact that Macedonia drew on the PCL only a few months after the arrangement had been agreed on may lessen confidence in the PCL.

Subsequently, Section 5 discusses the systemic implications of and problems associated with such preventive facilities and scrutinises the probable causes behind the lack of demand for this instrument by other countries and elaborates some proposals for promoting use of the FCL and PLL, such as better IMF outreach, longer duration for the facility, and reduction of the commitment fees. We address the issue of sufficiency of IMF resources if more demand for the FCL and PLL should arise and propose the use of contingent commitments to fund the IMF through a strengthening the New Arrangement to Borrow (NAB) or by allowing the Fund to borrow in capital markets. Additionally, we explore the possible synergies between the IMF's crisis prevention facilities and regional financial arrangements. Section 6 offers concluding remarks and policy recommendations.

2 IMF surveillance

Surveillance is the IMF's quintessential crisis prevention tool. As the Fund itself points out, "by virtue of its universal membership" it is *"uniquely placed to monitor and assess economic and policy spillovers across countries, advice on how to achieve global economic and financial stability (a global public good), and serve as a forum where members discuss each other's policies and collaborate"* (IMF 2010b).

Surveillance seeks to detect flaws in members' policies both at the country level through the annual Article IV consultations and at the global level through analysis in the context of publication of the World Economic Outlook (WEO). Its goal is to promote balanced growth and exchange rate stability by ensuring that countries do not implement policies leading to unsustainable financial or trade imbalances. As recently as 1999 the IMF strengthened its surveillance of financial sector issues with the Financial Sector Assessment Programmes (FSAP), under which it carries out comprehensive and in-depth analysis of an individual country's financial sector every five years together with the World Bank. In 2002, the Fund launched the Global Financial Stability Report (GFSR), published twice a year, in order to focus more carefully on financial flows and their sustainability. Additionally, in November 2008, the G20 asked the IMF and the Financial Stability Board (FSB) to collaborate on regular Early Warning Exercises (EWEs).

The efficacy of IMF surveillance is invariably questioned when crises erupt. In the aftermath of a crisis, the IMF typically seeks ways to strengthen surveillance in order to minimise the risk of the outbreak and spread of crises in the future; which sometimes has given rise to allegations that the Fund was trying to fight the previous crisis. For instance, after the Mexican "tequila crisis" of 1994, the IMF concluded that more effective surveillance required an improved collection of data, a more continuous policy dialogue, a better-focused surveillance of countries at risk and of where financial tensions were most likely to have spillover effects, and more candidness in surveillance. However, then-Managing Director Camdessus (1995) pointed out very clearly the main problem with all the proposals for strengthening surveillance in a statement which is still valid more than fifteen years later: *"I fear that implementing it [stronger surveillance] will not be a straightforward matter: experience shows that while countries tend to be very eager for surveillance over others, they are less keen on surveillance over themselves. It will be a critical challenge for international policy cooperation and for the IMF."*

The situation has not changed substantially over the years, and the Fund has often found itself accused of *"sleeping at the wheel"* (Goldstein / Mussa 2005), even when it has actually tried to address vulnerabilities. In order to improve the effectiveness of surveillance in light of the threat posed by global imbalances, the IMF in 2006 started to experiment with ways to deal with this problem. In particular, it launched its multilateral consultations on global imbalances. The aim was to identify spillover effects and serve as a mechanism for internalising the benefits of collective action. The IMF (2006b) hoped that its multilateral consultations would *"enable the Fund and its members to agree upon policy actions to address vulnerabilities that affect individual members and the global financial system, and [...] help policy makers to show that the measures they propose will be matched by meas-*

ures taken by others, with benefits to all. Each multilateral consultation will focus on a specific international economic or financial issue and directly involve the countries that are party to that issue". As history has shown, the multilateral consultations did not have any positive results in terms of crisis prevention, given the unwillingness of (large) member countries to adhere to IMF policy advice resulting from the multilateral consultations process.

The 2008 crisis led to a great deal of soul-searching within the IMF and in the international community on ways to improve surveillance (e.g., Aiyar 2010). Accordingly, the IMF has pushed strongly since that time for finding ways to strengthen multilateral surveillance and its integration with bilateral surveillance. In particular, the IMF (2011a) expressed its ambition to carry out *"better assessments of policy spillovers across countries; [i]mprove the understanding of the real sector's linkages with the financial system (macro-financial linkages), as well as mapping the connections in the global financial system; [s]trengthen financial sector surveillance, including by making this more of a focus of bilateral surveillance and making the financial stability assessment under the FSAP mandatory for systemically important financial centerscentres; and [m]ake sharper risks assessments through the Early Warning Exercise and the vulnerability exercises, thereby fostering more candid policy dialogue with country authorities."* Further efforts to improve surveillance and boost the crisis prevention toolkit of the IMF are certainly very important. Several authors have put forward suggestions in this regard (e.g., Truman 2010a).

Additionally, the huge costs associated with the 2008 crisis have prompted the G20 to make efforts at improving surveillance through enhanced policy cooperation. In order to strengthen policy cooperation with the aim of reducing global imbalances and to exert more peer pressure for improving the effectiveness of surveillance, the G20 launched the Mutual Assessment Process (MAP) at the Pittsburgh Summit in September 2009 (cf. IMF 2011b). Realising that the interconnectedness of global trade and financial markets in the twenty-first century will make effective international macroeconomic coordination more important than ever before, the G20 leaders asked the IMF to support implementation of the MAP in tracking progress in reaching the goals established in their "framework for strong, sustainable, and balanced growth". In particular, the IMF was mandated to establish consistency checks between individual country policies and their results at the global level, and to ensure that individual country policies do not have unintended negative repercussions on other countries and the world economy. The MAP thus seeks to address collective action problems while avoiding a form of non-cooperative equilibrium that would entail substantial welfare costs as a result of recourse to "currency wars", beggar-thy-neighbour policies, protectionism, and in general, nationalistic reactions that are self-defeating in the aggregate.

However, even with improved IMF surveillance at the national and global level, there is no doubt that crises will continue to occur time and again. Accordingly, the IMF needs to complement its crisis prevention toolkit with financial instruments for effectively warding off contagion, bandwagon effects and herd behaviour in financial markets. Crisis prevention facilities like the FCL and the PCL naturally complement the Fund's surveillance

activities since they are tailored to promote sound macroeconomic policies in eligible countries.

3 Crisis prevention facilities of the Fund

Initial discussions

The international community and the IMF have struggled for years to create a crisis prevention facility. As early as 1993, the IMF started to study the possibility of creating a contingent facility for countries which, although economically solid, might be the object of speculative attacks in a world in which capital market integration was gaining force. In effect, the IMF discussed the creation of the Short Term Financing Facility (STFF) in 1993 with the objective of *"helping members with strong policies deal with financial market volatility"* (IMF 2003a, 4). The facility was *"aimed at Fund members particularly vulnerable to large swings in capital movements induced by external conditions."* (IMF 2003a, 4)[1]

The proposed STFF did not materialise due to concerns by many members of the Executive Board about committing the Fund's resources without the usual phasing and conditionality attached to Fund programmes. It was feared that the IMF would not be capable of distinguishing countries under speculative attack due to contagion and requiring mere liquidity support from countries facing external disequilibrium and requiring adjustment on the part of the respective country. According to the IMF (2003a, 4), *"[t]he proposal was not adopted because of a range of concerns about the difficulty of assessing when markets have misjudged a particular country's policy stance, the risks of using Fund resources in the context of severe financial pressures without a framework of conditionality, as well as concerns about substituting Fund resources for other available short-term facilities."* These three issues, which we call the eligibility, the conditionality and the *"sufficiency of resources"* problem, were at the centre of discussions regarding the creation of a crisis prevention instrument at the IMF.

Another concern that was prominent not only in the STFF discussions but also invariably a factor in the discussion of crisis prevention instruments was moral hazard. The IMF defines moral hazard *"in the context of Fund financing"* as *"the risk that the availability of Fund financing may encourage reckless behavior among borrowing members and their creditors. It can arise if Fund involvement shields either the debtor or the creditor from facing possible negative consequences of their actions"* (IMF 2006a, 19). In the view of moral hazard *"vigilantes"*, any form of automatic access to IMF resources would assuredly worsen the moral hazard problem.

Mexico's financial and balance of payments crisis at the end of 1994 and the beginning of 1995 highlighted the importance of capital account issues for crisis prevention purposes. Indeed, Michel Camdessus (1995) described the Mexican crisis as the first crisis of the

1 See also IMF (1994a, 1994b).

twenty-first century, in the sense that it was “the first major financial crisis to hit an emerging market economy in the new world of globalized financial markets”. Arguably, the IMF at the time had not adapted its toolkit to meet the challenges of this new world.

The Contingent Credit Line

The idea of a Contingent Credit Line (CCL) resurfaced in the fall of 1998 after the Asian financial crisis. At that time, the issue of contagion was central, since the Asian crisis was spreading to many countries with fundamentally solid economies. Market pressures were emanating from this contagion and from bandwagon effects and herd behaviour rather than from weak domestic policies. Therefore, an IMF instrument to reassure markets of the strength of economic policies in many emerging markets was actively sought. The objective of this instrument was that financial markets would be able to differentiate between the risks faced by different economies and would not lump all emerging markets together in their risk assessment processes when making their investment decisions. Indeed, the IMF’s concern (2003a; 5) “was that the globalization of capital markets coupled with swings in investor risk appetite may lead to capital market pressures not resulting from weaknesses in domestic policies but from “contagion”.” Against this backdrop, the Fund devised a facility that was supposed to provide *ex ante* assurances of appropriate financial support, thereby helping to boost market confidence, and reduce the probability of a crisis. As a result, the CCL was designed to “provide assurances to members with demonstrably sound policies that Fund resources would be readily available in the event of financial market pressures due to external events” while creating *“further incentives for the adoption of sound policies and stronger institutional frameworks”* (IMF 2003a, 5) for the member countries.

The CCL was launched in April 1999 with a life cycle of two years and a review of its effectiveness after one year, and with unique features that distinguished it from regular Fund facilities (cf. IMF 1999). Contrary to regular IMF facilities, it did not contain programme monitoring and conditionality on for meeting various performance criteria. Instead, it had what is called *ex ante* conditionality or qualification requirements. Access to Fund resources was up-front instead of the usual phased access dependent on achieving the programme’s targets. The CCL offered automatic access to resources without the need for a formal review process. The aim of the CCL was firstly to provide incentives to countries to maintain strong macroeconomic policies and secondly to send strong positive signals to markets regarding the creditworthiness of the respective countries. It was hoped that this would counteract the stigma that countries tend to use IMF resources when facing severe imbalances and the need to put their financial house in order. The IMF (1999) press communiqué emphasised the preventive nature of the CCL and characterised it as a “measure intended solely for members that are concerned with potential vulnerability to contagion, but are not facing a crisis at the time of commitment”, in contrast to other facilities, such as the Supplemental Reserve Facility, which are to be used “by members already in the throes of a crisis.”

As it turned out, there were no requests for CCL resources as originally designed. The member countries were still concerned with the negative signal to markets that usually accompa-

nied an arrangement with the IMF. Moreover, several countries were concerned with the negative domestic signal that using an IMF facility would convey. Additionally, the eligibility criteria were very stringent, and only a handful of countries were seen as potential candidates. Many of the potentially eligible countries had begun to take action to "self-insure" against contagion through substantial reserve accumulation, others believed that their flexible exchange rate policy was a good buffer against speculative attacks, and still others saw strength in regional arrangements that would operate under conditions of stress in financial markets.

Another concern was the so called "exit problem". It was not clear to the members how the market would interpret the termination of a CCL. Many thought that markets would suspect that a country was exiting from the CCL because it no longer qualified for the insurance, and not because it did not need the insurance any more. This meant that once you entered into a CCL you were stuck with it. This was the case even though qualification requirements were very clearly spelled out under the CCL, and presumably markets could in effect verify why a country was exiting from the facility.

Another fact that reduced the attractiveness of the CCL was that it lacked complete "automaticity". The Board had to give its approval prior to a purchase. That is, the resources committed under the CCL could be refused when they were actually needed by the member country. This uncertainty was seen by many potentially eligible countries as an undesirable feature of the CCL. In general, there was a perception of rigidity in terms of eligibility, activation and disbursement. Of course, all of these rigidities had been introduced to the CCL to give assurances to IMF board members who remained sceptical of the merits of a CCL, believing that the CCL should have adequate safeguards for the use of IMF resources. Other objections to the CCL were in the financial area: the commitment fees was considered too high; the 12-month duration of CCL was considered too short, and the access amounts were considered too low.

Since there was no demand for the CCL, the facility was cancelled in November 2003. At the time, the IMF (2003b) stated: *"The fact that no member chose to use the CCL, despite some general interest, reflects both technical issues connected to the design of such a contingent facility, and the ongoing strengthening of the international financial system. Many emerging market economies have reduced their vulnerability to shocks through reserve accumulation, the adoption of flexible exchange rates, and other reforms."* However, the search for an effective crisis prevention instrument continued. The IMF's medium-term strategy in 2006 again included the search for *"a new vehicle for the provision of high access financing for crisis prevention [...] targeting emerging market countries that have strong macroeconomic policies, sustainable debt, and transparent reporting and that are making progress in addressing remaining vulnerabilities to shocks"* (IMF 2006a, 1).

The Reserve Augmentation Line

The Reserve Augmentation Line (RAL) incorporated the views from official sector representatives and market participants on ways to make a crisis prevention instrument more appealing. It sought to address many of the concerns in terms of design that had made the CCL unattractive. In particular, it proposed important changes in terms of the qualification

framework, monitoring structure, access levels, and financial terms. As was the case during the initial discussions on crisis prevention facilities, the idea was that the RAL should be useful for individual countries and for the system as a whole. The challenge thus was to strike the right balance between adequate insurance and moral hazards.

At the time of the discussion of the RAL in March 2007, the situation of the world economy still appeared relatively stable; there was no urgency to reach agreement on the several contentious points of the design of the RAL. This lack of urgency is manifested in the IMF's Executive Board conclusions with respect to the RAL. According to the records, *"some Directors remain[ed] skeptical about the need for and the viability of a new liquidity instrument, or [felt] that the currently proposed formulation of the RAL is unlikely to provide meaningful and reliable support for crisis prevention. [...] the staff has made good progress in addressing the concerns and suggestions made by Directors at the August seminar, but underscored the need to improve and clarify further various design issues of a possible RAL"* (IMF 2007). It was agreed that IMF staff would prepare a follow-up paper building on areas where there was broad agreement and with proposals for bridging areas where more progress needed to be made.

The Short-Term Liquidity Facility

The collapse of Lehman Brothers in September 2008 and the unfolding global financial crisis created the sense of urgency that had been missing before about establishing the RAL. The crisis caused a significant drying up of market liquidity worldwide, and many emerging market economies, even those that had maintained sound macroeconomic frameworks, were negatively affected. In this context, the Short-Term Liquidity Facility (SLF) was launched at the end October 2008 to help countries that despite strong initial macroeconomic positions and policies were facing short-term liquidity pressures in the midst of the most severe turmoil to hit global capital markets in decades.

Dominique Strauss-Kahn, then Managing Director of the IMF, highlighted the IMF's commitment "to promoting a coordinated and cooperative approach to dealing with the current crisis. […] *Exceptional times call for an exceptional response [...]. The Fund is responding quickly and flexibly to requests for financing"* (IMF 2008a). Indeed, the crisis led to a rapid establishment of the SLF in order to help improve liquidity conditions in global financial markets and avoid the spread of contagion from the epicentre of the crisis towards fundamentally sound economies with a strong macroeconomic framework.

The design of the SLF was based on several broad principles (cf. IMF 2008b): (i) strict eligibility of only *"those countries facing short-term, self-correcting balance of payments pressures arising from external developments rather than from domestic policy weaknesses"* (IMF 2008b, 3); (ii) quick creation with *"a premium on speed and simplicity"* (IMF 2008b, 3); (iii) large access with quick and streamlined disbursement conditions; (iv) no mission required prior to Board approval; (v) only *ex ante* conditionality; (vi) participation restricted to countries with very strong policies and fundamentals, sustainable public and external debt, and a history of implementing sound policies in order to safeguard Fund

resources; and (viii) a strict limit to the period over which resources can remain outstanding.

No country used the SLF, and it was discontinued with the introduction of the Flexible Credit Line (FCL), which represented an improvement over the SLF. Potential users of the SLF still considered that its capped access and short repayment period, as well as the inability to use it on a precautionary basis, were drawbacks for using the facility. It should be noted that several potential users of the SLF chose to arrange bilateral facilities from other countries rather than go to the IMF. Indeed, around the same time, the U.S. Federal Reserve established temporary reciprocal currency arrangements (swap lines) for 30 billion dollars with Banco Central do Brasil, the Banco de México, the Bank of Korea, and the Monetary Authority of Singapore, respectively.

The Flexible Credit Line

The unprecedented magnitude of the global financial crisis prompted a quick rethinking of the need to revamp the IMF's toolkit and led to a tripling of Fund resources, a substantial allocation of special drawing rights, and the creation of the FCL. All of these actions had been unthinkable for the international community just a few years prior to the crisis.

The FCL was launched in March 2009 as an instrument for reducing the likelihood of a crisis by boosting confidence in emerging market economies beset by severe turmoil in global financial markets. By augmenting access to official liquidity, it was to be a means of supplementing reserves at a time when markets were testing central banks' resolve to contain volatility in exchange markets. The objective was (and still is) to provide an effective alternative to costly self-insurance while reinforcing strong policies. Thus, creating synergies between the liquidity and credibility effects of Fund support was a key feature of the FCL (cf. IMF 2009a).

The G20 Leaders' Summit in Washington in November 2008 can be seen as the moment when the impasse for the creation of the FCL was finally broken. Countries that had been very concerned with safeguarding the IMF's resources at last agreed to introduce the flexibility required by such an instrument. It is important to recall that several members of the IMF's Executive Board had strong concerns about the FCL, fearing that the ease of access to it might induce a large precautionary use of Fund resources, thereby crowding out lending for crisis resolution. Moreover, there was concern with the absence of limitations on access, since this might lead to uneven treatment of members and reduce the predictability of Fund lending. Additionally, many were concerned that *ex ante* conditionality might not provide adequate safeguards for the use of Fund resources. Lastly, many highlighted the moral hazard, arguing that the FCL might undermine incentives for undertaking reforms or fully assessing risks.

Notwithstanding these concerns, the G20 Washington Summit Declaration of 15 November 2008 in effect committed the group to *"[h]elp emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support"* (G20 2008, 2). The Declaration also stressed the IMF's

"important role in crisis response, welcome[d] its new short-term liquidity facility, and urge[d] the ongoing review of its instruments and facilities to ensure flexibility." (G20 2008, 2) The key word here was *flexibility* since this mandate led to the creation of the FCL a few months later.

The FCL incorporated many of the design elements that several of the potential users had been advocating: large and up-front access to Fund resources; no *ex post* conditionality; a renewable credit line; a longer repayment period; no specific limit to the degree of access to Fund resources; flexibility to draw on the credit line at any time; and the possibility of treating it as a precautionary instrument (which was not the case under the SLF).

The IMF set very strict qualification standards in order to give adequate assurance to members that Fund resources were safeguarded in spite of the added flexibility of the FCL. These included *"an assessment 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"* (IMF 2009a). Moreover, the IMF explicitly spelled out the criteria it would be using to evaluate whether a member country was eligible for FCL. These included: (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 favourable 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) the absence of bank solvency problems that could pose the immediate threat of a systemic banking crisis; (viii) effective financial sector supervision; and (ix) data transparency and integrity (cf. IMF 2009b). However, countries need not show *"[s]trong performance against all these criteria"* – that is, the Fund left room for flexibility (and interpretation) by taking into account *"compensating factors, including corrective policy measures under way"* when assessing the criteria in the qualification process (IMF 2009b).

On 30 August 2010, the IMF enhanced the FCL by providing more flexibility in terms of access and length (cf. IMF 2010a). In particular, the duration of the credit line was doubled to a two-year period, and the notional cap on access of 1,000 per cent of quota was eliminated. Higher access and a longer duration for the FCL facility were introduced to provide the necessary insurance against tail risks that persist for periods longer than anticipated. This feature allows more time for shocks to dissipate and increases policy flexibility. These enhancements have improved the FCL's function as an increasingly attractive substitute for reserves. The enhancement of the FCL was part of the Fund's decisions to *"expand and reinforce [its] crisis-prevention toolkit and mark an important step in our ongoing work with our membership to strengthen the global financial safety net"* (IMF 2010a). Moreover, it affirmed that *"[t]hese reforms come as the G20 has made the strengthening of the global financial safety net an agenda item for its next meeting in Seoul, Korea in November 2010"* (IMF 2010a).

The Precautionary Credit Line

The Fund further enhanced its precautionary lending toolkit with the introduction of the Precautionary Credit Line (PCL). The PCL was created with the aim of providing an effective crisis prevention window for member countries whose fundamentals were in an intermediate range and hence did not qualify for the FCL. It seemed that countries in this category would be the ones that would benefit most from a crisis prevention facility of this type, since the confidence boosting effects and the incentive for pursuing strong policies would operate most effectively under these conditions (cf. IMF 2006a). In effect, the PCL was conceived as a way to tailor Fund conditionality to the particular strengths and fundamentals of member countries, and to put emphasis on *ex ante* conditionality. With the PCL, the IMF sought to diminish the stigma prevalent in many countries regarding IMF financing.

The PCL was also perceived as an insurance-type instrument that would encourage countries to take pre-emptive measures to avoid a crisis. Its design rewarded countries implementing strong policies and targeted a broader spectrum of countries which are relatively more vulnerable compared with those that qualify for the FCL. Nevertheless, to qualify for a PCL a country must have a positive evaluation in five broad areas, namely (i) external position and market access; (ii) fiscal policy; (iii) monetary policy; (iv) financial sector soundness and supervision; and (v) data adequacy. The main attributes of the PCL are *"[s]treamlined ex post conditions designed to reduce any economic vulnerabilities identified in the qualification process, with progress monitored through semi-annual program reviews"* and *"[f]rontloaded access with up to 500 percent of quota made available on approval of the arrangement and up to a total of 1000 percent of quota after 12 months"* (IMF 2010a).

When the PCL took effect at the end of August 2010, Dominique Strauss-Kahn expressed the hope that *"[t]he enhanced Flexible Credit Line and new Precautionary Credit Line will enable the Fund to help its members protect themselves against excessive market volatility"* (IMF 2010a).

The Precautionary and Liquidity Line

The PCL was replaced in November 2011 by the Precautionary and Liquidity Line (PLL), which *"builds on the strengths and broadens the scope"* (IMF 2011n) of the PCL. The PLL combines a qualification process similar to that for the FCL with ex-post conditionality intended at addressing vulnerabilities identified during qualification. The PLL was launched against the backdrop of the European debt crisis, which created fears of financial contagion across the eurozone and beyond, to include a shorter-term facility to support liquidity over six months.

Under the PLL, countries can enter arrangements with a duration of either six months or one to two years. The six-month PLL arrangement is accessible for countries with actual or potential short-term balance of payments needs and can be renewed only after a two-year "cooling-off period" from the date of approval of the previous six-month PLL ar-

rangement. Under the six-month PLL, countries can draw up to 250 percent of their quota; higher amounts of up to 500 percent of quota are *"available in exceptional circumstances where the member country's increased need results from the impact of exogenous shocks, including heightened stress conditions"* (IMF 2011n). Under PLL arrangements with a duration of one to two years countries can access a maximum of 500 percent of their quota for the first year and a total of 1,000 percent of quota during the second year.

4. Experiences with the FCL and PCL

4.1 Experiences with the FCL

First users of the FCL

Mexico was the first country to use the FCL in April 2009, followed by Poland and Colombia in May. After more than fifteen years of struggling with the design of a crisis prevention instrument, one had at last been put in place and was being used by Fund members. When the IMF's Executive Board approved Mexico's FCL, John Lipsky, then the First Deputy Managing Director of the IMF, called the approval (which was also the largest financial arrangement in the Fund's history at the time) *"a historic occasion"* and *"the consolidation of a major step in the process of reforming the IMF and making its lending framework more relevant to member countries' needs"* (IMF 2009c).

In May 2009, at the time the FCL was approved for Poland and Colombia, the Executive Board expressed its concerns about a possible further deterioration in the global economic environment. When the IMF Executive Board approved the FCL to Poland, the Fund highlighted that it should contribute to boost market confidence and Mr. Lipsky stressed that *"[t]he FCL arrangement for Poland will also have a positive regional impact"* (IMF 2009e). Upon approval of the FCL to Colombia, Mr. Lipsky highlighted the precautionary nature of the instrument, the additional insurance provided by the FCL, and its *"important role in bolstering confidence in the authorities' policy framework and strategy at a time of heightened global uncertainty"* (IMF 2009g).

These three pioneer countries (the "FCL3") – all of which have renewed their respective FCL arrangement with the Fund twice (cf. Table 1) – have provided an excellent test run of the FCL. The FCL3 country authorities have stated that their objective of using the FCL is to protect their economies from current tail risks due to the existing turbulence in global financial markets. They believed that the large amount of resources committed by the IMF under the FCL gave markets the necessary assurances that they would have the financial wherewithal to confront extreme conditions in financial markets. Moreover, FCL3 country authorities felt that the large up-front resources upon which they can draw without any further conditionality under the FCL are in fact the best guarantee that these resources will not need to be used. In effect, the signalling effect of a large treasure chest discourages

speculation against the currency of an FCL country. The three countries thus regard the FCL as a considerable boost to their usable reserves.[2]

Table 1: FCL arrangements to date

	2009	2010	2011
Mexico	17 April 1,000% of quota SDR 31.52bn 1 year	25 March 1,000% of quota SDR 31.53bn 1 year	10 Jan 1,500% of quota SDR 47.29bn 2 years
Poland	6 May 1,000% of quota SDR 13.69bn 1 year	2 July 1,000% of quota SDR 13.69bn 1 year	21 Jan 1,400% of quota SDR 19.17bn 2 years
Colombia	11 May 900% of quota SDR 6.97bn 1 year	7 May 300% of quota SDR 2.32bn 1 year	6 May 300% of quota SDR 3.87bn 2 year

Source: Compiled by authors with data from the IMF
Note: SDR stands for Special Drawing Rights

The results for these countries under the FCL can be used to analyse the strengths and weaknesses of this crisis prevention instrument. In particular, they make it possible to evaluate whether some of the FCL-related concerns mentioned above have materialised, such as the stigma issue or the moral hazard problem. Additionally, the impact of the FCL on national economies can also be assessed, including the market reaction, the impact on reserve accumulation, and the question of whether strong policies have been reinforced.

The IMF's Assessment of FCL qualification criteria

As with any such facility, the IMF staff must always prepare a report on the fulfilment of the qualification criteria by the country applying for the FCL before the FCL can be discussed and approved by the Board. A summary of the IMF staff's assessments of the qualification criteria for the FCL3 countries is provided in the following. For an overview of key economic figures of the FCL3 see Table 2.

(i) Sustainable external position: The IMF staff analysis of the external position of the FCL3 was very positive when the initial arrangement was agreed. The evaluation documents highlighted the relatively low external debt levels of the FCL3 and the fact that the current account deficits were at low and sustainable levels, financed largely by foreign direct investment flows. Moreover, external debt sustainability analysis showed that the external position of the FCL3 was robust when subjected to a variety of hypothetical

2 See IMF (2009d, 8); IMF (2009f, 13); IMF (2009h, 12).

shocks. The Fund's assessment in the subsequent renewals of the FCL in 2010 and 2011 basically corroborated that the FCL3 had continued to fulfil this criterion.[3]

(ii) Capital account position dominated by private flows: With respect to the capital account being predominantly composed by private flows, the analysis certified that for all FCL3 the vast majority of capital flows originated in the private sector. The fulfilment of this criterion was corroborated in the 2010 and 2011 renewals of the FCL.

(iii) Track record of steady sovereign access to international capital markets at favourable terms: With respect to access to international capital markets, the analysis was very clear that the FCL3 were among those best rated in credit markets. In the case of Mexico, the IMF (2009d, 12) pointed out that *"Mexico is among the highest rated emerging markets, as has been reflected in a track record of low sovereign external borrowing spreads, including during periods of stress such as during the 2001 recession". In the case of Poland, it was highlighted that "[a]s recently as January 2009, Poland was able to issue sovereign debt in international capital markets"* (IMF 2009f). Even though Colombia does not have an investment grade rating, the IMF analysis pointed out that even though Columbia's *"sovereign debt rating is one notch below investment grade"* its *"sovereign spreads and vulnerability indicators are similar to those of countries with higher credit ratings"* (IMF 2009h). The fulfilment of this criterion was confirmed in the 2010 and 2011 renewals of the FCL.

(iv) Relatively comfortable reserve position: With respect to reserves, the analysis highlighted that the FCL3 reserve levels were adequate for "normal" times. However, it also pointed out that the environment of high volatility and global deleveraging called for an increase in reserve backup, i.e. increased buffers, which could be provided by the FCL. This assessment was repeated in the 2010 and 2011 renewals of the FCL.

(v) Sound public finances, including a sustainable public debt: With respect to public finances and the debt position, the IMF assessments pointed out that all FCL3 have a sustainable public debt and a sound fiscal situation, in spite of the fact these countries had recently increased their public debt levels as a consequence of weakness in their economies due to the global crisis in 2007 and 2008, and as a result of some fiscal stimulus provided to the economy. The IMF also highlighted the strong institutional setting that underpins the maintenance of fiscal responsibility. In the case of Mexico, the IMF (2009d) stated that *"[f]iscal policy is underpinned by the balanced budget rule as well as the authorities' commitment to keep the augmented public sector deficit (including development banks and other levels of government) at a level that stabilizes the overall public debt."* In the case of Poland, the IMF (2009f) stated that beyond a *"strong commitment to the Maastricht criteria, fiscal policy has been underpinned by the Polish Public Finance Act – prompting corrective action when public debt reaches trigger levels of 50 and 55 percent of GDP – and by the constitutional ceiling on public debt of 60 percent of Gross Domestic*

3 See IMF (2010d); IMF (2010e); IMF (2010f); IMF (2011d); IMF (2011e) and IMF (2011f).

Product (GDP).”[4] In the case of Colombia, the IMF (2009h) stated that *“the authorities' rules-based fiscal framework over the medium term clearly establishes their commitment to further debt reduction.”* The basic thrust of this analysis was reaffirmed in the 2010 and 2011 FCL renewals.

(vi) Low and stable inflation, in the context of a sound monetary and exchange rate policy framework: Regarding inflation and the monetary and exchange rate policy framework, IMF evaluation reports concluded that the FCL3 countries have gained credibility through their inflation-targeting frameworks and a flexible exchange rate policy. Inflation expectations are regarded as being firmly anchored at relatively low levels, and the depreciation of the respective currencies during the 2007–2008 crisis did not lead to substantial inflation. The basic thrust of this analysis was reaffirmed in the 2010 and 2011 FCL renewals.

(vii) Absence of systemic bank solvency problems that might constitute the imminent threat of a systemic banking crisis: With respect to systemic bank solvency problems, the IMF concluded that the FCL3 countries all had well-capitalised banking systems which had undergone stress tests showing that they were able to cope with severe shocks to the system. Bank profitability was deemed good, with banks showing adequate liquidity. The same diagnosis was delivered in the 2010 and 2011 renewals of the FCL.

(viii) Effective financial sector supervision: Regarding financial sector supervision, the IMF considered all FCL3 countries to have strong and effective supervisory and regulatory frameworks in their financial sector. The IMF felt that the FCL3 could intervene promptly with the banks if needed and that they had made substantial progress in implementing the recommendations contained in their respective FSAPs. The IMF noted that the FCL3 had improved their coordination of different supervisory bodies as a result of the 2008 financial crisis.

(iv) Data transparency and integrity: The IMF pointed out that all FCL3 countries have good data quality, that they have been subscribers to the Special Data Dissemination Standard (SDDS) for many years, and that the Fund's Reports on Observance of Standards and Codes (ROSC) were very positive in terms of the evaluation of periodicity and timeliness requirements. The same diagnosis was delivered in the 2010 and 2011 FCL staff report assessments.

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4 The Council of the European Union's (2011, 6) assessment of the Polish fiscal situation was more critical: *“Poland has strengthened its fiscal framework over the years. However, in order to assure sustainability of public finances in the medium to long term the existing fiscal rules and medium-term programming procedures do not appear to provide for sufficient transparency of the budgetary process, incentives for coordination between various tiers of government and flexibility to address macroeconomic shocks and imbalances. The fiscal rules should also be based on sufficiently broad budgetary aggregates and should be consistent with the European System of National and Regional Accounts (ESA 95). According to the Commission's latest assessment, the risks with regard to long-term sustainability of public finances appear to be medium.”*

Table 2: Key economic figures for Colombia, Macedonia, Mexico and Poland

		2007	2008	2009	2010	2011
Colombia	GDP per capita, USD current prices	4,794	5,303	5,207	6,360	6,980
	Inflation, average consumer prices, % change	5.54	7.00	4.20	2.27	3.25
	General government revenue, % of GDP	27.18	26.33	26.52	24.37	25.26
	General government total expenditure, % of GDP	28.21	26.29	29.05	27.47	28.27
	General government fiscal position, % of GDP	-1.03	0.04	-2.53	-3.10	-3.02
	General government net debt, % of GDP	22.96	20.96	26.93	28.09	29.18
	Current account balance, % of GDP	-2.86	-2.94	-2.20	-3.09	-2.62
	External debt stocks	121.15	104.53	131.89	135.35	
	(% of exports of goods, services and income)					
	External debt stocks (% of GNI)	21.91	19.81	23.03	22.84	
	Total reserves (% of total external debt)	47.95	50.98	47.94	44.52	
	Total reserves in months of imports	5.32	5.00	6.08	5.61	
Macedonia	GDP per capita, USD current prices	3,998	4,828	4,550	4,483	5,012
	Inflation, average consumer prices, % change	2.26	8.36	-0.81	1.51	4.40
	General government revenue, % of GDP	32.21	32.48	30.52	30.07	30.86
	General government total expenditure, % of GDP	31.62	33.41	33.17	32.54	33.37
	General government fiscal position, % of GDP	0.59	-0.93	-2.65	-2.47	-2.51
	General government net debt, % of GDP	20.19	18.58	21.08	23.08	23.84
	Current account balance, % of GDP	-6.95	-12.83	-6.70	-2.75	-5.54
	External debt stocks	94.07	88.87	150.09	131.84	
	(% of exports of goods, services and income)					
	External debt stocks (% of GNI)	53.52	48.16	60.83	65.07	
	Total reserves (% of total external debt)	54.42	45.08	40.91	39.23	
	Total reserves in months of imports	4.24	3.18	4.63	4.22	
Mexico	GDP per capita, USD current prices	9,786	10,255	8,174	9,522	10,803
	Inflation, average consumer prices, % change	3.97	5.13	5.30	4.15	3.37
	General government revenue, % of GDP	21.29	22.98	22.35	21.98	21.58
	General government total expenditure, % of GDP	22.46	24.09	27.03	26.28	24.82
	General government fiscal position, % of GDP	-1.18	-1.11	-4.69	-4.31	-3.24
	General government net debt, % of GDP	31.13	35.58	39.07	39.31	39.34
	Current account balance, % of GDP	-0.86	-1.49	-0.72	-0.54	-0.95
	External debt stocks	60.12	59.04	68.67	62.68	
	(% of exports of goods, services and income)					
	External debt stocks (% of GNI)	17.56	17.34	19.76	19.52	
	Total reserves (% of total external debt)	48.83	50.93	58.25	60.27	
	Total reserves in months of imports	3.15	3.19	4.32	4.18	
Poland	GDP per capita, USD current prices	11,157	13,887	11,296	12,323	13,967
	Inflation, average consumer prices, % change	2.49	4.22	3.45	2.58	4.03
	General government revenue, % of GDP	40.31	39.52	37.16	37.85	40.25
	General government total expenditure, % of GDP	42.19	43.19	44.51	45.70	45.79
	General government fiscal position, % of GDP	-1.88	-3.68	-7.35	-7.86	-5.54
	General government net debt, % of GDP	10.22	9.94	15.04	21.35	24.52
	Current account balance, % of GDP	-6.23	6.60	-3.99	-4.47	-4.81
	Total reserves in months of imports	3.67	2.83	4.84	4.85	

Sources: Compiled with data from IMF WEO September 2011 and World data Bank January 2012

Impact of FCL on FCL3 countries

Conditions on financial markets improved for all FCL3 countries after the announcement of the respective FCL arrangement. In general, the exchange rate appreciated, private and sovereign risk spreads (measured by Emerging Markets Bond Index (EMBIG) and Corporate Emerging Markets Bond Index (CEMBI) spreads, respectively) narrowed, and the stock market posted a strong recovery (cf. Figures 1–3).

Indeed, in its respective reviews, the IMF highlighted the positive impact of the FCL on all three economies. In the case of Mexico, the IMF (IMF 2009j; 3) stated that *"[a]round the announcement of the intent to seek support under the FCL, Mexican CDS spreads and the exchange rate staged a strong recovery [...] while risk relativities versus other emerging market peers also improved"*. In the case of Poland, the IMF (2009k, 17) reported that *"Poland is benefiting from the FCL arrangement. The strengthening of the zloty, reduction in sovereign external spreads, increasing capital inflows, and declining yield on government bonds have in part reflected the stabilizing impact of Poland's FCL agreement"*. In the case of Colombia, the IMF commented that *"[e]quity prices in the region have rebounded – in some countries by over 40 percent – with Colombia's stock market index returning to pre-Lehman levels by end-June. EMBI spreads for Latin American countries fell by about 135 basis points (160 basis points for Colombia) from April to September"* (IMF 2009, 3). Overall, the IMF evaluation of the FCL seems very positive in terms of the latter's stabilising effect on markets in the FCL3 countries.

The positive effects, however, should not be overemphasised or attributed solely to the FCL. As can be seen in Figures 1–3, most indicators had already started to improve before the announcement of the arrangement. In Columbia, for instance, the interest on government bonds dropped slightly after the first FCL announcement, but this was the continuation of a decline in interest rates that had started in the third quarter of 2008. Moreover, yields on Columbian government bonds started to rise again less than two weeks after the announcement.[5]

Critics of the FCL argue that the improvement in financial market conditions for the FCL3 countries was part of an overall improvement and that it would be a mistake to attribute the improvement in financial conditions of the FCL3 to the FCL arrangements. For instance, Fernández-Arias / Levy-Yeyati (2010) argue that the improvement in financial conditions after the April 2009 London Summit was a generalised phenomenon in which the FCL3 countries benefited from a rising tide that lifted all boats. They compare a control group with the FCL3 countries' performance and find no significant difference be-

5 Moody's announced a possible upgrade of Colombia's foreign currency bonds on 9 September 2010 and an actual upgrade from Ba1 to Baa3 on 31 May 2011. This was followed by Standard and Poor's upgrade of Colombia's long term foreign currency bonds to "BBB-" from "BB+" on 31 May 2011 and an upgrade by Fitch Ratings of the sovereign foreign currency credit rating for Colombia by one notch to BBB-minus on 21 June 2011. While these upgrades were not linked by the rating agencies to Colombia's FCL arrangement (which was indeed much earlier, on 11 May 2009), the rating agencies confirmed the IMF's positive outlook for Colombia. The ratings of Mexico and Poland have not changed since these countries entered into their respective FCL arrangements.

tween the two groups in terms of the improvement of financial conditions. Fernández-Arias and Levy-Yeyati hence conclude:

> *"[i]t is nevertheless tempting to attribute the tightening of EM spreads after the London G20 summit in April 2009 to the creation of a new approach in the form of the IMF FCL or the momentum created by the bilateral swaps with the US Fed and the expectation of their widespread application. In this way of thinking, the new facilities offered widespread potential protection and were behind the favorable undercurrent, having therefore a substantial effect beyond the particular countries to which they were applied. However, the new facilities appear too selective to account for the widespread improvement across the country spectrum. In fact, a more rigorous examination of this optimistic interpretation of the evidence also casts serious doubts about it and suggests that the widespread improvement of risk spreads after the London summit cannot be attributed to the availability of these new liquidity facilities."*

Fernández-Arias and Levy-Yeyati certainly have a point in saying that it is difficult to attribute an improvement in the FCL3's financial conditions to just one factor such as the FCL at a time when the world was undertaking a large number of measures to recover from the severe crisis of 2008. It is important to remember the unprecedented set of measures implemented to recover from the recession and prevent crises like this one from repeating themselves in future. The G20 Leaders' Statement of the London Summit in April 2009 highlights the actions taken (cf. G20 2009b). These included boosting the public international resources of international financial institutions and trade finance by USD 1.1 trillion in order to support credit, growth and jobs. Moreover, G20 countries embarked on unprecedented and concerted fiscal expansion; interest rates were cut to near-zero levels, unconventional instruments to provide monetary stimulus were utilised and significant and comprehensive support was given to banking systems in order to restore the normal flow of credit. When evaluating the FCL's impact one thus has to be aware of several other forces which were also at work at the time.

Furthermore, it should also be remembered that the FCL is a crisis prevention instrument for countries with very strong fundamentals. The FCL should not be expected to lead to an overnight improvement of a country's credit rating, its sovereign bond spreads, its exchange rate, or its domestic bond rates. An FCL country should be in a good position regarding all these indicators to begin with. Like an individual who buys health insurance, one is expected to be in good health at the time of the purchase.[6] The coverage is intended to help cope with an unexpected situation or event. Health insurance *per se* will not lead to improved health. To look for correlations between the FCL and financial market indicators, in a sense, misses the point of the FCL. Indeed, the purpose of the FCL, among other things, is to lower the probability that a country will face a financial crisis; this in turn should have a positive effect on financial variables. However, the magnitude and timing of the effect seem to be very difficult to estimate given all the other variables that impinge on

6 The Polish Finance Minister Jacek Rostowski likened the FCL to *"installing good locks on the doors"* to increase security and stated that Poland would activate the FCL only *"if we had a serious attack on the zloty or a sharp depreciation of the currency. But these problems are less likely because everybody on the market knows that we have this access."* (Rastello 2010)

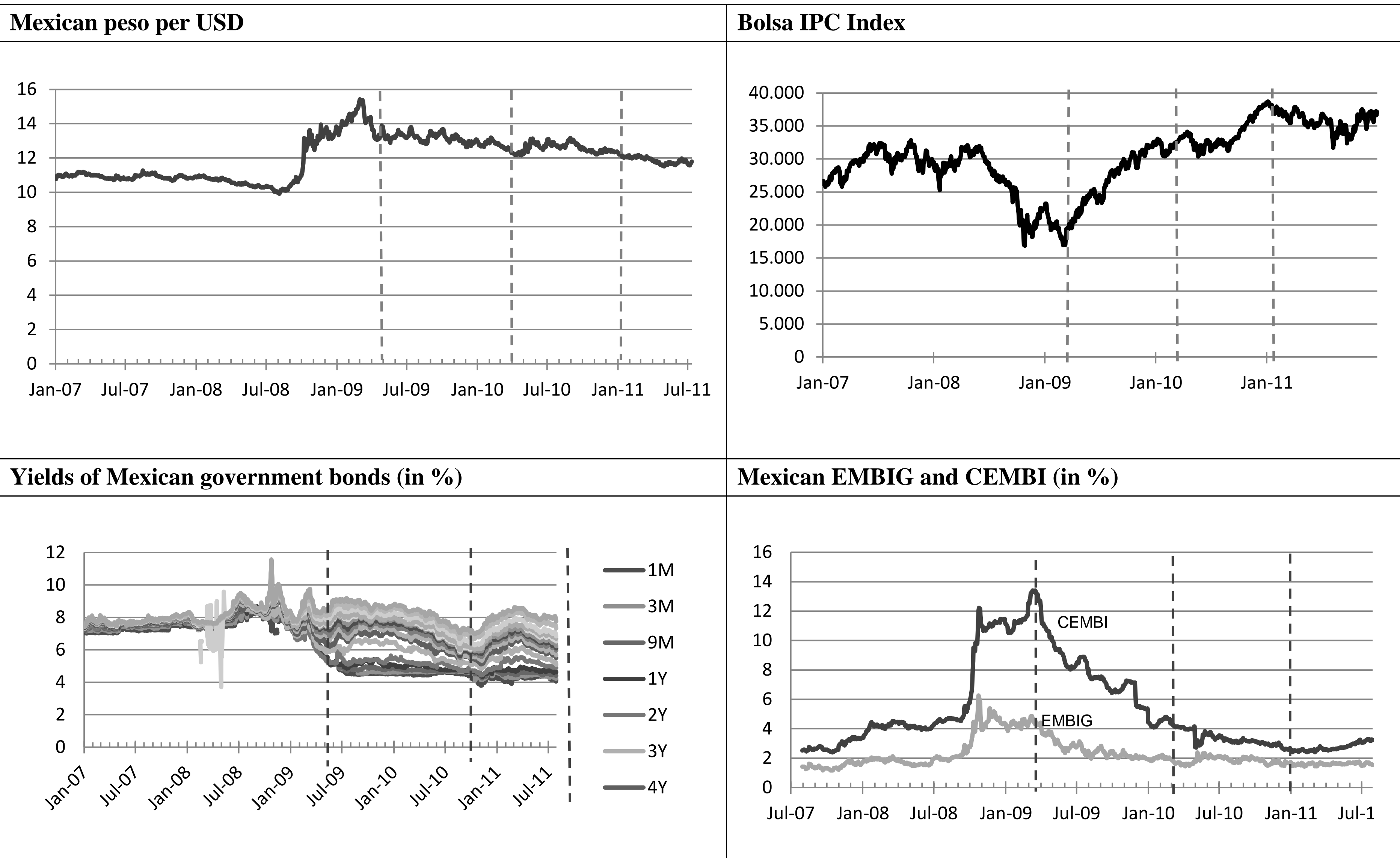
this probability.[7] Indeed, as we are well aware, estimating this probability is the job of credit rating agencies (which for their part have come under heavy criticism for misjudging sovereign risks in many cases, not least in the case of Greece).

Moreover, the available FCL evidence indicates that the three pioneer countries apparently value the FCL highly, since all of them have renewed the instrument on two occasions. This fact is a signal that the FCL is considered useful by countries which want to benefit from the FCL's function as insurance. Moreover, it signals that there has been no stigma problem and that markets have regarded the process favourably. Market analyst reports indicate that the FCL has been correctly understood as an instrument that boosts a country's contingent liquidity. For instance, after Mexico requested its first FCL arrangement, Oxford Analytica (2009) published a report titled "IMF aid boosts Mexico's credibility".[8] On the renewal of Mexico's FCL arrangement in January 2011, Bloomberg quoted a currency trader to the effect that *"[t]his is a cheap way of accumulating reserves and it's good for the peso [...]. It's a vote of confidence and it tells you that Mexico has solid fundamentals"* (Martinez 2011).

7 Market analysts seem to share this view. A day after Mexico requested a renewal and increase of its FCL in December 2010, Bloomberg cited from a JPMorgan Chase & Co. note to clients: *"This, in our view, is a clear signal of Mexico's strong fundamentals [...]. However, we believe this is not a short-term market mover, as this is something that Mexico somehow had before."* (Martinez 2010)

8 In this report, Oxford Analytica (2009) described the FCL request as *"mutually beneficial for Mexico and the IMF"* since Mexico would *"significantly boost its standing as a country with a solid policy record and prospects"*, while the IMF would benefit from *"Mexico break[ing] the stigma attached to countries requesting resources from the IMF, which has pushed countries in relative good economic health to seek to avoid the institution, borrowing massively from the World Bank and regional development banks."*

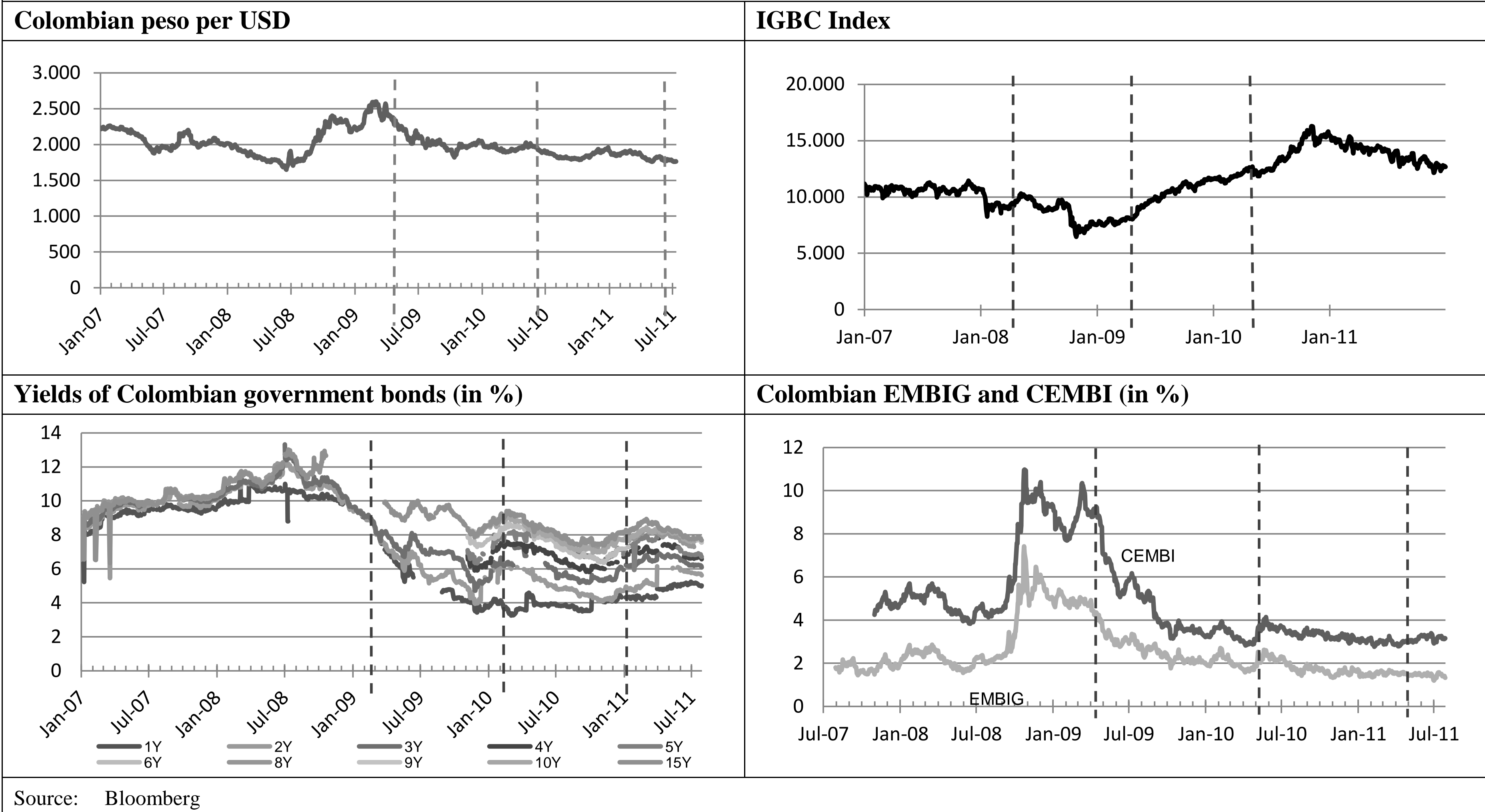
Figure 1: Effect of FCL announcement on Mexican macro and financial indicators



Source: Bloomberg

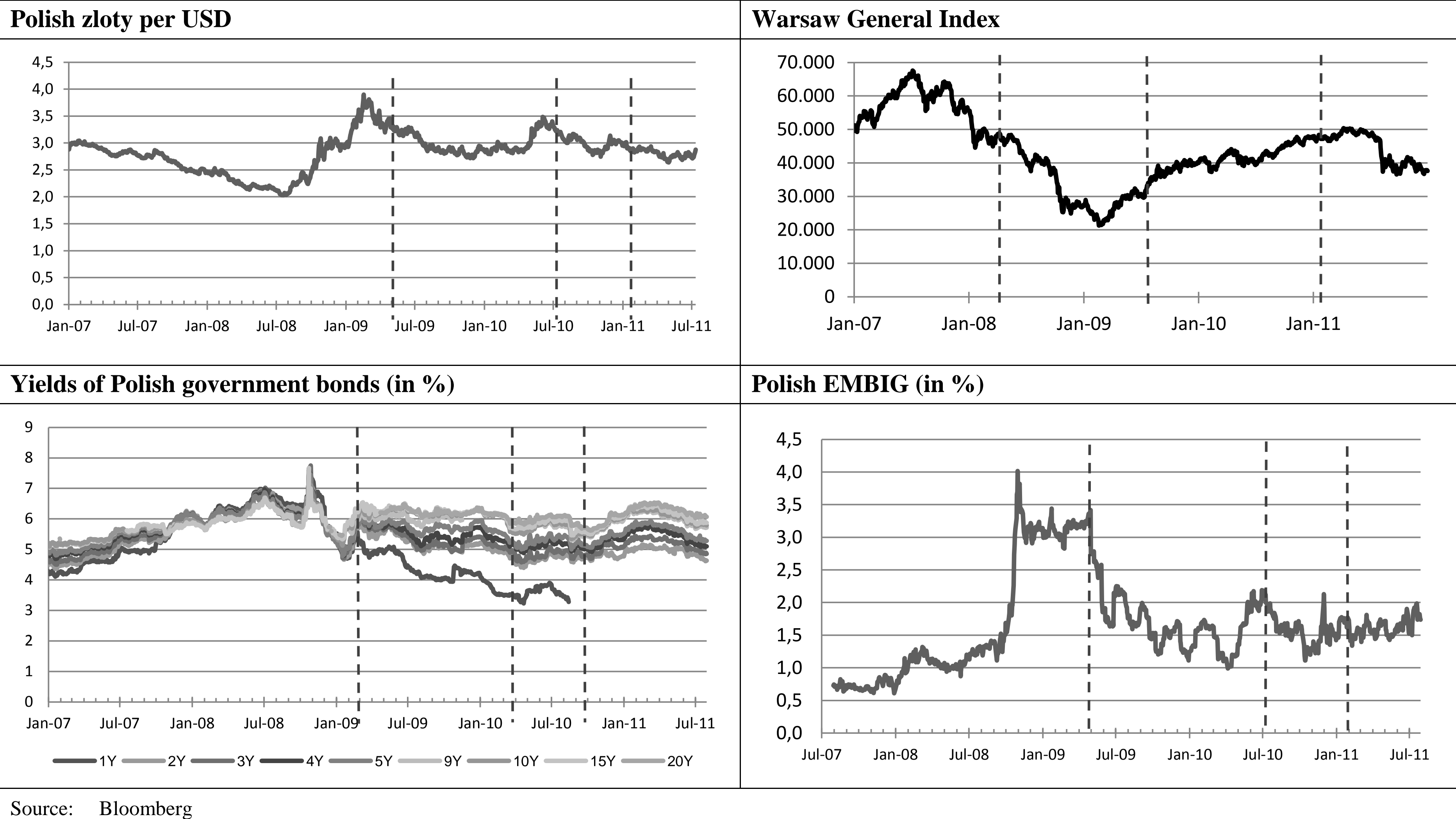
Note: EMBIG stands for JPMorgan's Emerging Markets Bond Index Global and CEMBI for JPMorgan's Corporate Emerging Markets Bond Index

Figure 2: Effect of FCL announcement on Colombian macro and financial indicators



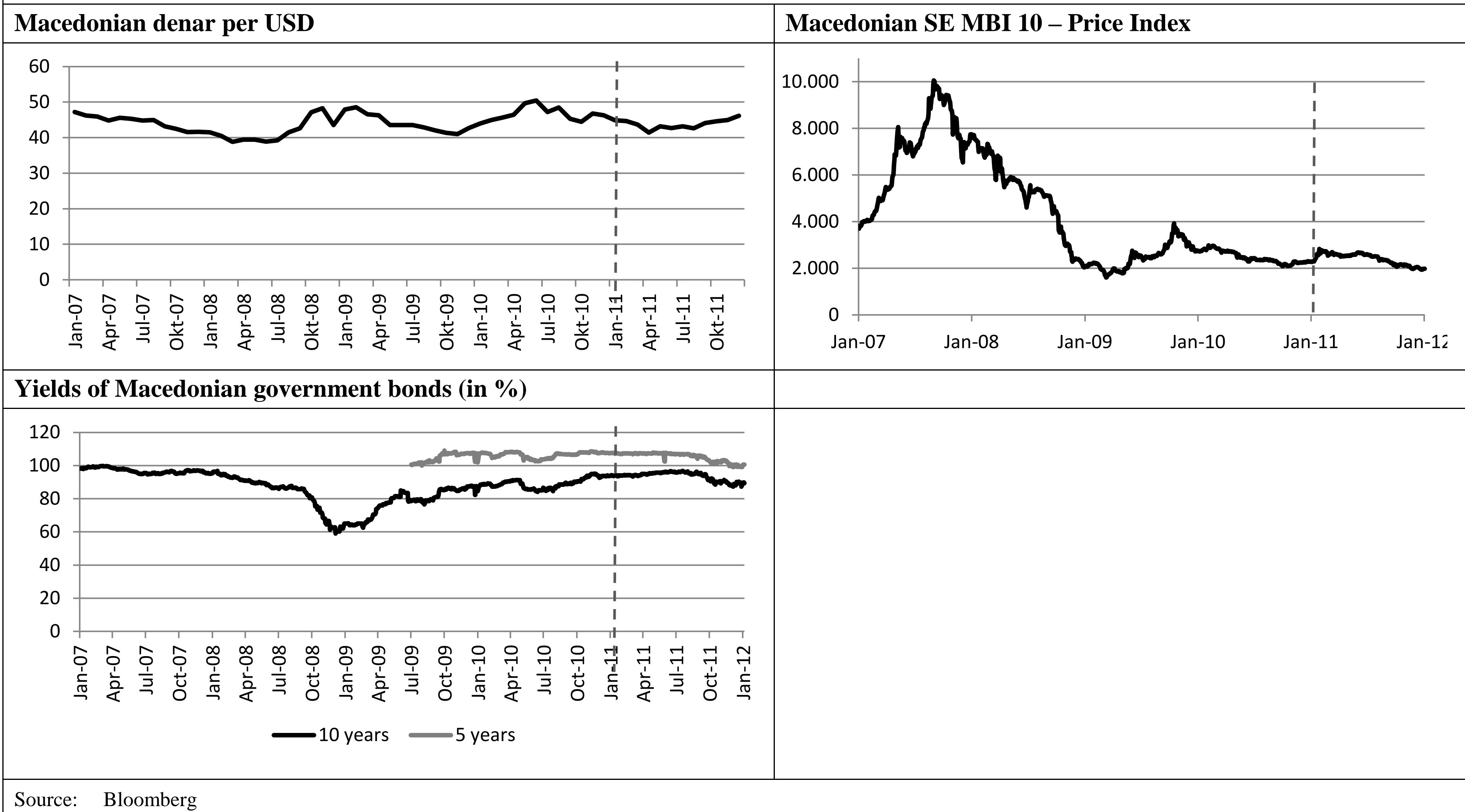
Source: Bloomberg

Figure 3: Effect of FCL announcement on Polish macro and financial indicators



Source: Bloomberg

Figure 4: Effect of PCL announcement on Macedonian macro and financial indicators



Source: Bloomberg

4.2 Experience with the PCL

The PCL found only one user: on 19 January 2011, the IMF approved a two-year arrangement of Special Drawing Rights (SDR) 413.4 million for Macedonia for cumulative access to 600 percent of quota. Macedonia requested the PCL to help protect its economy against external risks in view of the financial volatility prevalent in the region. The IMF stated that *"having a PCL in place would send a positive signal that policies are sound and that the authorities have adequate resources to draw if needed, which should strengthen investor confidence and improve access to international capital markets"* (IMF 2011g, 5). The immediate market response was moderately positive (Figure 4), but like in the above-discussed cases of the FCL, the PCL announcement for Macedonia itself should not be seen as a major game changer regarding financial market's assessment of the Macedonian economy.

Upon approval of the arrangement, Naoyuki Shinohara, Deputy Managing Director and Acting Chair, stated: *"Despite the broadly favorable outlook for growth and macroeconomic stability, vulnerabilities to spillovers from economic and financial volatility in the region remain. The PCL will mitigate the risk of contagion, including by signaling sound policies. In light of Macedonia's strong fundamentals, the absence of balance of payments pressures at present, and the generally positive economic prospects, Macedonia is not expected to draw upon the resources available under the PCL. Nevertheless, the availability of these resources, if needed, will provide important insurance against the possibility of adverse external developments."* (IMF 2011g)

However, the expectation that Macedonia would not draw upon its PCL arrangement with the Fund were only short-lived. Contrary to the FCL3 countries, which have not drawn a single SDR from their respective arrangements, Macedonia utilised the PCL resources only two months after the arrangement was in place: on 23 March 2011, the IMF reported that Macedonia had drawn EUR 220 million out of the EUR 390 million available to it under the PCL.[9] The reason given by the Macedonian authorities for drawing upon the PCL was *"the changed circumstances brought about by the early elections, including a delay in the planned Eurobond issuance"* (IMF 2011h).

This action by Macedonia raised doubts about the precautionary nature of the PCL arrangement, particularly given the fact that the withdrawal was made only two months after the IMF had certified the qualification criteria for Macedonia, including access to external market financing. Some commentators were severely critical of the drawing, arguing that it was motivated by the government's need to *"plug gaping budget holes, the outcomes of its populist spending spree on the eve of early parliamentary elections"* (Vaknin 2011).

Nonetheless, in its first review of Macedonia's performance under a PCL arrangement in September 2011 the IMF reaffirmed Macedonia's continued qualifications for accessing PCL resources and emphasised that Macedonia continued *"to pursue sound economic*

9 Under the current PCL arrangement, Macedonia has access to SDR 344.5 million (500 percent of quota) in the first year, rising in the second year to a cumulative SDR 413.4 million.

policies that are consistent with the program supported by the [PCL] arrangement" (IMF 2011j). According to the Fund, Macedonia's decision to draw on the PCL arrangement *"highlighted remaining external vulnerabilities"* and a need for *"strengthening debt management policies and practices"*, in particular a necessity for *"improving access to external funding and [...] developing the domestic public debt market"* (IMF 2011j), issues the Macedonian government was now addressing with the support of IMF technical assistance.[10]

After just one year it is still too early to fully evaluate experiences with the PCL, especially since only one country has used it. However, what is clear is that, as with the FCL, countries are not lining up to request a PCL arrangement or a PLL, its replacement, even though the PCL/PLL would seem to be of value for countries whose fundamentals are in an intermediate range.

5. Problems and concerns with the Fund's precautionary facilities

5.1 Why are more countries not taking advantage of the Fund's precautionary facilities?

The experience gained with the FCL3 would make it appear that the FCL has been a very successful instrument. The FCL has had a truly precautionary effect, as corroborated by the fact that not a single SDR has been used under the FCL notwithstanding the very volatile world economic and financial situation during the 2009-2011 period. The countries using the FCL seem to be satisfied with the instrument, since all three of them have renewed the FCL two times and have taken advantage of the larger amounts available and the longer duration. Indeed, the FCL3 country authorities stated that the FCL has been instrumental in diminishing their need to accumulate larger amounts of precautionary reserves. Market analysts have regarded the use of the FCL by all three countries as positive and have recognised it as an important complement to the countries' own reserves. Analysts have understood that the FCL is granted only to countries with an excellent track record of policy implementation, and this fact has accordingly helped to improve assessments of the respective country's creditworthiness. Of course, none of the FCL3 have suffered a balance of payments problem or a financial crisis. The experience with the now abandoned PCL is still very recent, and the case of Macedonia is open to different interpretations.

In spite of success with the FCL, only a few countries have made use of this crisis prevention instrument that took the IMF so long to develop and was recently enhanced by the IMF in terms of available amounts and lifetime periods. One possible explanation is that

10 On 24 August 2011, Standard and Poor's lowered Macedonia's long-term local currency sovereign credit rating to "BB" from "BB+". While the downgrade was due to a revision of Standard and Poor's methodology and assumptions for rating sovereign governments, the agency also highlighted *"structural rigidities, inflexible government expenditure structure, and residual latent (albeit declining) risk of inter-ethnic tensions"*.

countries which might potentially qualify have acquired "sufficient insurance" through the accumulation of reserves and because, in effect, there is no further demand at this time for the instrument. Indeed, the members show a strong preference for building up their own reserves in order to avoid having to turn to the IMF (IMF 2010c). Another plausible explanation is that the mere existence of the Fund's precautionary arrangements and the rapid process of accessing them provide sufficient insurance as long as market participants feel that a country meets the respective qualification requirements. In this scenario, potentially eligible countries benefit without the need of going through the formal qualification process. Another possibility is that potentially eligible countries believe that the risk of contagion or a rapid, unpredictable turnaround in market confidence for their countries has diminished considerably, and hence they do not require a crisis prevention instrument.

In the following we discuss three further, major problems associated with the FCL and PCL/PLL from the perspective of a member country which might be interested in these facilities: (i) the stigma problem; (ii) the entry and the exit problem; and (iii) the cost of insurance.

The stigma problem

The IMF (2010c) conducted a survey (prior to the most recent enhancements of the FCL) to try to fathom the reasons behind the relatively scarce demand for the FCL. In the stakeholders' responses, the issue of stigma attached to Fund lending is still strongly present as a leading argument against the use of the FCL. This "stigma" means the political stigma of having recourse to the IMF. The IMF (2009i, 12) itself is aware of the stigma problem and acknowledges that *"[i]t is no secret that members resist approaching the Fund for financing due to the political stigma of such borrowing, and in the process may allow their problems to fester. Additional evidence of such stigma is provided by the existence of a clear demand for 'Fund-type' financial support by other international financial institutions and central banks."*

Examples of alternative sources of crisis finance include the provision of balance of payments assistance via Development Policy Loan (DPL) by the World Bank, similar contingency lending by regional development banks and an unprecedented rise of swap agreements between central banks of major economies and their counterparts in smaller countries.[11] For instance, when Indonesia, despite the country's relatively strong economic position, experienced refinancing problems after the outbreak of the global financial crisis, the government did not consider IMF support an option because of the negative reputation the Fund still has in the Indonesian society as a legacy of its role during the Asian crisis. Instead of going to the Fund, the Indonesian government turned to the World Bank and secured a USD 2 billion DPL with a deferred drawdown option (DDO) in March 2009 (cf. World Bank 2011) – a form of contingent financing somewhat similar to the IMF's new

11 For the World Bank's crisis response see World Bank (2010). For an analysis of central bank swap arrangements during the crisis see Aizenman et al. (2010).

crisis prevention facilities.[12] The World Bank's DPL DDO was the largest component in a USD 5.5 billion contingent financing facility to which also the governments of Australia and Japan and the Asian Development Bank contributed. Even though the DPL DDO was never disbursed, its approval sent a strong positive signal to international and domestic markets and boosted market confidence so that Indonesia was able to raise more than USD 6.3 billion through five bond issuances in the capital markets between September 2008 and March 2009.

In order to promote a more intense use of its precautionary facilities by countries that face financial contagion problems, the Fund needs to address the factors that are hindering demand. First, it must improve its outreach activities in order to diminish the political stigma of IMF involvement. In a large number of developing and emerging economies, not least in Latin America and East Asia that went through Fund programmes in the 1980s and 1990s, the Fund's reputation is still very poor and Fund policies are seen as following the interests of the largest shareholders (that of the US government in particular).[13] As Fernández-Arias and Levy-Yeyati (2010) point out, *"[n]ow that fears of being punished by the market have been put to rest [after the experience of the FCL3], it became clear that, if there is a stigma associated with IMF involvement, its roots are political rather than economic."* The IMF needs to address these concerns head on. In particular, the IMF ought to continue the governance reform process in order to address the widespread concern that its policies are dominated by the large shareholders; it should also increase the sense of ownership on the part of the smaller member countries. The large member countries also need to deliver on their promise of an open and transparent selection process for the position of managing director when the position becomes vacant again.

The long-standing perception that countries have recourse to the IMF only in a crisis situation is also not conducive to strengthening the crisis prevention toolkit of the IMF (The Economist 2009; Goldstein 2009). However, the existence of a well-functioning crisis prevention instrument is fundamental if the IMF is to permanently occupy its intended position as the central institution of the international monetary system. Otherwise, the IMF will go through cycles of relevance and irrelevance, depending on whether a crisis is present in the world economy. The examples of the FCL3 countries should be used to point out the benefits attached to crisis prevention actions and to highlight the positive nature of the relationship between the IMF and the member countries in this arena. This is a challenge for the communication strategy of the IMF and requires the full support of the Executive Board. In particular, the Executive Board, the management and the IMF staff need

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12 The DPL DDO is a contingent credit line for IBRD-eligible borrowers that have met the World Bank's pre-approval criteria, which include an appropriate macroeconomic policy framework and satisfactory programme implementation. Under a DPL DDO, the borrowing country can defer disbursement for up to three years, renewable for an additional three years. The DPL DDO can be activated at any time during the three year drawdown period unless the World Bank has notified the borrower that one of the drawdown conditions is not being met any more. For further information on the DPL DDO see World Bank (2012).

13 It is hence not surprising to hear allegations that only countries whose governments are seen as relatively cozy with the US – namely Mexico, Colombia and Poland – have requested an FCL.

to embrace the FCL, to recognise its success, and to support actions that will provide the IMF with the contingent resources needed for this instrument.

The entry and exit problem

The entry – or first mover – problem describes a situation in which a country seeking insurance via a precautionary facility may be suspected by the markets of having hidden vulnerabilities. After all, why should a country with “very strong economic fundamentals and institutional policy frameworks” (in the case of the FCL) seek extra insurance through the IMF? The fear is that seeking IMF insurance could be interpreted as a sign of weakness and hence cause the opposite of what it aims to do, namely to boost market confidence in the economy in question. As discussed, the experiences of the FCL3 give no reason to assume that a country seeking an FCL would encounter an entry problem. The case may be different with the PCL, given that it was intended for member countries whose fundamentals are in an “intermediate range” and hence do not meet the criteria for an FCL. Moreover, the recent experience with Macedonia may have set a negative precedent for the PCL: after all the Macedonian government drew on its PCL arrangement with the Fund only two months after the IMF had certified that Macedonia met all PCL qualification criteria, including that of access to external market financing. This raised doubts about the precautionary nature of the PCL arrangement and might have deterred other countries from seeking a PCL.

The exit problem, on the other hand, describes a situation in which non-prolongation (“graduation”) of a precautionary arrangement may unsettle markets if it is perceived that the country in question no longer qualifies and that the arrangement was therefore terminated by the Fund. The termination of insurance could cause market uncertainties and worsen the countries’ financing conditions if the exit from the precautionary arrangement is not properly communicated and accompanied by credible economic fundamentals. However, since the qualification requirements under the various precautionary arrangements are clearly spelled out, markets can verify whether a country continues to qualify or not. This should reduce the concerns countries may have that they would be forced to cling to such an arrangement once they have entered it. To boost market confidence upon graduation, it may be useful for the IMF to carry out a final graduation assessment in which the IMF checks whether the exiting country would fulfil the criteria for prolongation of the arrangement. If this is the case, the exiting country could be given an option to enter into a new follow-up arrangement within a six-month period after graduation with an expedited qualification assessment.

Cost of insurance

A further point that may affect a country’s decision to apply or not apply for a precautionary arrangement is the cost of insurance. While the cost of drawing on a precautionary arrangement is the same as under an SBA, countries that seek an FCL/PCL/PLL arrangement with the Fund also need to pay a commitment fee that increases with the level of access available (it is refunded if they opt to draw on it). The average commitment fee

levied on a 500 / 1000 / 1500 percent of quota arrangement is 24 / 27 / 40 basis points (IMF 2011k; IMF 2011l). For instance, Mexico's annual payment for its USD 72 billion FCL amounts to USD 286 million (SDR 180 million). While this is a significant cost, it pales when compared with the costs of holding foreign currency reserves (which in the current environment has a negative carry for many countries). The cost of insurance also has to be seen in relation to the benefits of having this insurance, even if these are hard to quantify.

As with other non-concessional IMF facilities, the actual borrowing cost under the FCL/PCL/PLL varies with the scale and duration of lending, with the lending rate being tied to the IMF's market-related interest rate (or basic rate of charge). The effective interest rate under the FCL/PCL/PLL (like that of the SBA) for access between 500 and 1000 percent of quota is currently between 2.2 and 2.8 percent, rising to about 2.6 to 3.5 percent after 3 years, and higher for access above 1,000 percent of quota as a means of discouraging large and prolonged drawing. In addition, the borrowing country also has to pay the flat 50 bps service charge required for all Fund disbursements.

For Macedonia, the costs of drawing EUR 220 million from its PCL arrangement in March 2011 were below what it would have paid under commercial borrowing conditions if the costs of its recent commercial borrowing are taken as a reference.[14]

We conclude that there are several forces at work which inhibit more generalised use of the IMF's precautionary facilities. On the demand side, the predominant factors are political stigma attached to the use of Fund resources, a situation characterised by abundant reserves held by the main emerging market countries, the recent experience of ample swap lines arranged between central banks, uncertainty regarding whether a country qualifies for the FCL, and possibly also a fear of not qualifying. On the supply side, the IMF does not seem to be actively promoting the instrument. The current critical situation in some countries in which the IMF is intensively involved certainly implies that it has other priorities. Moreover, the IMF may be concerned about the sufficiency of Fund resources for its traditional lending activities. It is clear that under current rules, the FCL absorbs a huge amount of the Fund's liquidity due to the size of the resources committed, a problem also discussed below.

5.2 Further problems with the Fund's precautionary facilities

Besides these issues affecting the demand for the Fund's precautionary facilities, there are also problems on the lending side. These are (i) the moral hazard associated with *ex ante* conditionality; (ii) the "freezing" problem; and (iii) concerns that unconditional liquidity provision by the Fund would create inflationary pressures and require central banks to provide ample liquidity through the SDR mechanism.

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14 According to Vaknin (2011), Macedonia paid 4.2 percent on its last tranche of short-term Eurobonds and 9.8 percent on its 3-year Eurobond issued in 2009.

The moral hazard of ex ante conditionality

As mentioned earlier, the moral hazard problem associated with *ex ante* conditionality has been a long-standing concern of economists inside and outside the Fund and has been the subject of much debate within the Executive Board ever since discussions about creating precautionary facilities started. Regarding concerns by IMF creditor countries, there has been no hint of moral hazard considerations in terms of looser policies implemented by the FCL3 because of IMF insurance. Moreover, the IMF has benefited because the effectiveness of its surveillance of these economies has improved. The pilot cases have been working precisely as intended in the design of the FCL. This means that the IMF should be able to promote its insurance policy to its member countries more effectively. For the world economy, a reduction in the probability of countries facing a crisis means a better environment. With the FCL, the IMF has been able to commit a level of access to its resources which is much higher and more in line with current capital flow volatilities or contagion risks, and has enhanced the incentives for countries to adopt strong policies before capital account pressures emerge. These actions have helped to boost market confidence and reduce the probability of a crisis. In financial terms, the IMF has benefited because it has committed a large amount of its resources which on the other hand have not been withdrawn, which implies income in the form of the commitment fees charged for FCL resources.

In the case of the PCL, as mentioned above, there have been allegations of moral hazard, inasmuch as Macedonia was accused of having abused its PCL. However, the IMF did not consider the withdrawal to be out of line with the guidelines of the PCL, and on 23 June 2011 the IMF (2011i) stated that "[o]n the basis of the authorities' record in the first part of this year and their continued commitment to achieving the goals of their economic program for the remainder of 2011, the mission will recommend completion of the first PCL review to IMF management." Nonetheless, some analysts will assuredly see their moral hazard concerns as confirmed by the Macedonian case.

The freezing problem

In the context of problems with several crisis countries that require significant amounts of Fund financing, it is important to analyse ways of leveraging Fund resources. In the particular case of the FCL and PCL/PLL, the current practice is to freeze the total amount of resources committed under the FCL and PCL/PLL, i.e., the Fund must put aside 100 percent of the resources committed under the FCL/PCL/PLL. As of 17 November 2011, the FCL accounted for 43 per cent of the total amounts committed by the IMF under current financial arrangements in the general resources account (Table 3). This huge share has led to concerns that greater use of the FCL by relatively large countries could tie up an enormous amount of IMF resources. Consequently, the use of resources for precautionary purposes could lead to a crowding out of resources for crisis resolution purposes.

However, it should be recognised that contingent financing under the FCL could be funded with contingent sources of funds for the IMF. It seems excessive to reserve 100 per cent financial backing for a facility in which not a single SDR has been withdrawn under

these programmes during a three-year period of great volatility in the world economy. Indeed, as pointed out by Lipsky (2010) *"[t]he Fund's membership made the application of such contingent facilities [FCL] credible by agreeing to provide substantial amounts of contingent funding through the expanded New Arrangement to Borrow (NAB)."*

Table 3: Current financial arrangements (GRA) as of 17 November 2011

	Amount agreed (bn SDRs)	Outstanding (bn SDRs)	Amount agreed / total amounts (%)
Extended Arrangements	43,546	17,326	26.40
Stand-by Arrangements	50,653	42,554	30.71
FCL	70,328	0	42.64
PCL	413	197	0.25
Total	164,941	57,502	100.00

Source: Compiled by authors with data from IMF (2011c).

Another potential instrument that the IMF could make use of as a contingent funding source is the SDR mechanism. Indeed, the SDR could be used for backing up the contingent financing provided by the IMF. In reviewing the role and function of the SDR, it has been argued that SDRs could be issued on a transitory basis or on-lent to countries in support of strong policy programmes in the context of a liquidity crisis. Truman (2010b; 15), for instance, suggests that the IMF amend its Articles of Agreement to *"allow the IMF to approve a special, temporary allocation of SDR in a crisis, perhaps subject to endorsement by the International Monetary and Financial Committee (IMFC) and prior to action by the Executive Board, without requiring an 85 per cent weighted majority vote of IMF governors […]. The subsequent cancellation of the SDR over a five-year period would follow a declaration of the end of the crisis and might require only a majority vote"*. Truman also suggests the activation of Fund borrowing in international capital markets. The sole availability of this mechanism would give confidence to markets that the IMF is thoroughly equipped to face crisis situations.

Furthermore, the Fund should explore the establishment of links between usage of its precautionary facilities and available contingent financing from regional financing arrangements (RFAs). By linking IMF resources to resources from RFAs, not only could the size of a precautionary arrangement be increased, a collaboration between RFAs and the Fund in providing a joint precautionary arrangement could also boost the acceptance of such a programme, since it would increase the sense of regional ownership.

Concerns over inflationary pressures from unconditional liquidity provision by the Fund

Lastly, a concern with unconditional liquidity support from the Fund is often raised by the central banking community. The fear is that the Fund might create excessive unconditional liquidity which would require *de facto* central bank participation to ensure the liquidity of the SDR system. In particular, there is worry that the creation and issuance of additional SDRs might flout the monetary independence of the central banks which issue the main

reserve currencies and force them to enlarge their balance sheet by requiring them to buy SDRs from countries with liquidity needs in exchange for their own currencies.[15]

However, as Cooper (2011) points out, *"[t]he allocation [of SDRs] per se has no monetary effect, simply providing participants' monetary authorities (usually ministries of finance or central banks depending on the domestic arrangements) with an additional contingent claim on SDR Department participants – contingent, since use of SDRs under the designation mechanism requires a balance of payments or reserve position need (Article XIX.3)."* Even if SDR holdings are exchanged for freely usable currency, which would in most cases mean dollars or euros, this would not always imply an increase in money supply, but often only a transfer of foreign exchange from one country to another without monetary effect (Cooper 2011). Even though the issuers of freely usable currencies created money in exchange for SDRs, they could sterilise money creation if it exceeds the desired level. The inflationary impact should hence be limited even in the case of large cumulative SDR allocations. The discretion to cancel existing SDR allocations at times of strong global demand and inflation concerns is an additional safeguard (IMF 2011m).

6. Conclusions and recommendations

Economic and financial crises carry enormous costs in terms of output loss and employment, as evidenced by the recent systemic crisis. Therefore, a fundamental aspect of international monetary cooperation is to step up efforts directed at crisis prevention. For many years, the IMF has been aware of the value of crisis prevention and has tried to improve its surveillance over countries' economic policies to this end. Unfortunately, the historical record shows that surveillance has not been very effective in deterring the build-up of large imbalances. The recent crises prompted important improvements in the surveillance process by strengthening surveillance, particularly in the financial sector, through the FSAP, the GFSR, and the EWEs, which are valuable instruments for timely identification of trends and policies that may lead to a crisis down the road. Additionally, the G20 MAP is being developed with the aim of identifying the spillover effects of countries' domestic policies. It should be instrumental in exerting greater peer pressure for the detection and correction of imbalances at their initial stages as a means of preventing imbalances from evolving into major disequilibrium in the world economy.

Surveillance, if effective, is the ideal crisis prevention tool. However, the lessons of experience suggest that its effectiveness depends on the will of the largest economies to determine their domestic policies by taking into account their impact on the rest of the world. This is an evolutionary process that has to be supplemented with other tools of crisis prevention. In this context, and considering that the world economy will never be exempt from crisis, the fortification of the IMF's crisis prevention toolkit through creation of the FCL and PCL represents an important boost to the architecture of the international mone-

15 This view was recently expressed, for instance by Weber (2011): "substantial new SDR allocations and the use of SDRs [...] would influence global liquidity conditions and even interfere with the monetary policy of those central banks that issue the major reserve currencies."

tary system. The initial experience with the FCL has been very positive. It has been used as a truly precautionary facility. Not a single SDR has been withdrawn by the three pioneer FCL countries, notwithstanding the volatile world economic and financial environment of 2009-2011. The FCL has been a valuable supplement to their reserves and has provided a valued insurance policy against tail risks, as corroborated by the renewal of the FCL on two consecutive occasions. Moreover, the FCL has created the right incentives for countries to maintain strong macroeconomic policies.

The experience of the FCL pioneer countries shows that moral hazard concerns in terms of looser policies which might arise because a country carries IMF insurance have not materialised. Accordingly, it is fair to say that the FCL has improved the effectiveness of IMF surveillance over these economies. This is beneficial for the world economy, since a reduction in the probability of a country facing a crisis means a less volatile environment. With the FCL, the IMF has been able to commit a much higher level of access to its resources to crisis prevention in a way which is more in line with current capital flow volatilities and contagion risks. This has boosted market confidence and reduced the probability of a crisis. The IMF's own financial position has benefited from the commitment fees charged to FCL resources.

The experiences with the PCL are still inadequate for drawing conclusions, especially since only one country has signed up for it. The Macedonian example, however, is not very encouraging, given that it drew on the PCL just two months after passing the qualification criteria. It remains to be seen whether the PLL, which has replaced the PCL, will attract more interest.

The challenge for the international financial community and the IMF is to promote the use of precautionary facilities by countries facing contagious pressures, to build firewalls early on when such pressures arise to effectively prevent financial contagion. The first step is for the IMF to improve its outreach activities in order to diminish the political stigma of IMF involvement. It must transmit the message that usage of its precautionary facilities does not mean that a country is in a crisis situation or that it has hidden vulnerabilities. A better differentiation between the IMF's crisis prevention instruments and traditional emergency financing or "crisis resolution" instruments is required. The existence of a well-functioning crisis prevention instrument is fundamental for the IMF's permanent position at the centre of the international monetary system. The promotion of crisis prevention instruments such as the FCL and PLL requires the full support of the Executive Board. In particular, the Executive Board, along with the IMF's management and staff, need to embrace the FCL and PLL and to support actions that will provide the IMF with the contingent resources needed for ensuring the credibility of these instruments. Otherwise the IMF will go through cycles of relevance and irrelevance depending on whether a crisis is present in the world economy.

Furthermore, the Fund should explore and promote the establishment of links between use of the FCL/PLL and available contingent financing from RFAs. Given the Fund's stigma problem, RFAs have become an attractive alternative to IMF lending (McKay et al. 2011). While RFAs can be constructive in preventing or combating financial crises, and a healthy

competition for surveillance and ideas between RFAs and the IMF should be welcome, dangers for (global) financial stability may arise when an RFA undermines the Fund's authority and *complicates* the Fund's work instead of *complementing* it. Hence, ways are needed to ensure an efficient interaction between RFAs and the Fund. The FCL and PLL could be useful tools in this respect. For instance, in the case of the Chiang Mai Initiative Multilateralisation (CMIM) in East Asia, CMIM member countries under current conditions can access only 20 percent of available resources from the CMIM without an IMF programme. This has led, in effect, to a situation in which the CMIM has not been used, despite demand for liquidity support during the global financial crisis. To make the CMIM fully effective and free it from IMF stigma, some argue that this link should be severed as soon as possible (Sussangkarn 2010; Kawai 2010). However, recognising the FCL/PLL as a sufficient condition for drawing on the CMIM beyond the first 20 percent would be a way of maintaining the IMF-CMIM link while allowing CMIM member countries to draw on the CMIM without needing to enter into a standard IMF programme (cf. Henning 2011; Volz 2012). Establishing similar linkages with other RFAs could help improve the interaction between RFAs and the Fund on the one hand and make the FCL and PLL more attractive to member countries on the other.

In order to address the resource issues connected with active promotion of its precautionary facilities, the IMF should be adequately endowed with resources. Moreover, it should be allowed to leverage its resource endowment by general recognition that contingent financing under the FCL needs to be funded with contingent sources of funds for the IMF. Maintaining a 100 per cent effective financial backup for a facility in which not a single SDR has been withdrawn under these programmes during a three-year period of great volatility in the world economy seems unduly restrictive and an unnecessary drain on the IMF's regular usable resources. The backing of FCL and PLL arrangements directly through the expanded NAB should be thoroughly explored. Another potential instrument to be used as a contingent funding source is the SDR mechanism. Indeed, the SDR could serve as a backup for the contingent financing provided by the IMF.

Finally, the IMF should continue to seek ways to enhance the attractiveness of the FCL and PLL, for instance by further prolonging the duration of FCL/PLL programmes in order to give greater certainty to countries and by linking FCL/PLL qualification and review process more closely to ongoing Fund surveillance.

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