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# Expanding Global Liquidity Insurance through Precautionary Lending: What the IMF Can Do

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Related Working Paper: Expanding Global Liquidity Insurance: Myths and Realities of the IMF's Precautionary Credit Lines

The IMF has been a provider of a global public good—of global financial and economic stability—since its inception. In the wake of the global financial crisis, it undertook a series of reforms to its lending facilities to strengthen its ability and that of its member states to manage volatility imposed from outside and to help prevent and lessen the magnitude of future crises. The reforms included the adoption of two new lending instruments: the Flexible Credit Line (FCL), introduced in 2009, and the Precautionary and Liquidity Line (PLL), introduced in 2011.[1] They are meant to serve as precautionary measures[2]—effectively, as insurance—for member states with a proven track record of prudent economic and financial management, enabling a rapid response to temporary balance of payment needs created by regional or global shocks.

There are a number of features that should make the Flexible Credit Line and the Precautionary and Liquidity Line attractive for member states. There is no cap on the funds available under the FCL (the actual size of the credit line is determined on a case-by-case basis) while under the PLL, member states can access up to 500 percent of their quota over a two-year agreement. These represent considerable sums: Mexico, a current FCL user, has access to $88 billion in liquidity support or 700 percent of its quota, which is equivalent to roughly 50 percent of its international reserves. Moreover, unlike conventional IMF arrangements, the FCL involves no post-approval conditionality —once a country's request for the credit line is approved, it can request disbursement anytime—and PLL arrangements imply only limited post-approval requirements.

Yet, the IMF's precautionary instruments remain underutilized. To date only three countries—Colombia, Mexico, and Poland—have access to the FCL, and one country—Morocco—to the PLL. The slow uptake of these instruments is puzzling given countries' continued efforts to self-insure via reserve accumulation, the proliferation of regional pooling arrangements and swap lines, and the apparent satisfaction of the four current users, as evidenced by continued renewals of the credit lines. Particularly at a time when uncertainty in the global economy is increasing and growing geopolitical tensions are introducing additional risks, many emerging economies could benefit from having more insurance.

## What factors could explain the precautionary credit lines' slow uptake?

In our recently published CGD Working Paper, we investigate and debunk four common myths regarding the low uptake of the two credit lines: 1) too stringent qualification criteria that limit country eligibility; 2) insufficient IMF resources; 3) high costs of precautionary credit; and 4) the economic stigma associated with IMF assistance. We show, in fact, that the pool of eligible member states is likely to be seven to eight times larger than the number of current users; that with the 2016 quota reform IMF resources are more than adequate to support a larger precautionary portfolio; that the two IMF credit lines are among the least costly and most advantageous instruments for liquidity support countries have; and that market reaction as well as the economic impact following an FCL or PLL arrangement for the current qualifiers has been unequivocally positive.

Nevertheless, beyond these four common myths, a few critical concerns remain that may hamper demand as well as the supply of the IMF's precautionary credit lines:

- **The qualification criteria set by the IMF for the FCL and the PLL are too vague for reliable self-assessment, deterring applications from a number of qualified candidates.** Based on the economic and policy fundamentals of the current qualifying countries (Colombia, Mexico, and Poland for the FCL and Morocco for the PLL), the pool of eligible member states for both credit lines far exceeds the number of current users. Our analysis of emerging economies suggests that there are around 18 additional member states that would likely qualify for the FCL alone, and several more would be eligible for the PLL. Yet, the high degree of ambiguity in how the IMF determines a member state's eligibility provides a disincentive for new applications. Eligibility for the FCL—a product designated for "very strong" performers—is evaluated against several dozens of indicators across nine broadly defined policy areas. In the case of the PLL—offered to member states with "sound" economic fundamentals and institutional policy frameworks—applicants are assessed against performance in five broad policy areas and a long list of associated quantitative measures. There is no official list of qualifying countries or minimum/maximum thresholds that would definitively include or exclude a country from eligibility for the FCL or the PLL. The IMF also provides very littleguidance on what weight any given policy area, economic, or institutional indicator carries in assessing a country's eligibility. As a result, many states face considerable uncertainty over whether their application would be accepted. This could act as deterrent for policymakers to invest time, effort, and political capital in pursuing access to these credit lines.

- **It is unclear how large of a share of its resources the IMF is willing to dedicate to precautionary lending, even though it clearly has the capacity to finance a greater number of users**. As the IMF quota reform became effective in January 2016, its 'hard' quota resources increased to over $660 billion, while the New Arrangements to Borrow (NAB) and its bilateral agreements currently provide an additional $590 billion (combined) in supplemental resources. Thus, the IMF has the capacity to easily accommodate a dozen or more FCL or PLL arrangements. However, to what extent the Fund staff or its shareholders represented on the Board have the willingness to expand the number of FCL and PLL users and what share of the IMF's resources they are prepared to dedicate to precautionary finance is not clear. On the one hand, the IMF's repeated efforts both before and after the global crisis to offer insurance-like instruments for crisis prevention suggests that the Fund is well aware of their potentially large and positive contribution to global financial stability. The Fund has also worked to make its precautionary facilities more attractive over the years, further underlining its commitment to their broader uptake. On the other hand, having no (FCL) or very limited (PLL) ex-post conditionality, the two contingent credit lines represent a considerable departure from the IMF's traditional lending practices. This might make a number of shareholders wary of their expansion.

- **The potential political repercussions of an IMF arrangement may discourage new applicants, even if the economic impact of an FCL or PLL approval appears to be positive.** Though evidence has been accumulating on favorable market reactions and positive economic impact following a country's approval for either of the two credit lines, concerns over political repercussions may linger. Policymakers could perceive any agreement with the IMF—even for one marketed as a 'premium' product with no conditions attached—as a risk to their political reputation, opening them up to criticism from the opposition and the media, and with a potential for losing voters. There are some encouraging developments: a 2014 IMF review noted that perceptions about the Fund among policymakers, particularly in Asia—where political stigma, probably as a result of the IMF-supported programs during the 1997-98 currency crisis, remained strong—had since moved from negative to neutral. Nevertheless, "stigma associated with the use of IMF resources" continued to be rated as one of the most critical factors inhibiting FCL and PLL use in an 2013 IMF-sponsored survey of country authorities in 54 emerging and small advanced economies. Unlike with economic performance, there is no before-and-after data from the current FCL or the PLL qualifiers to measure 'political' impact—for example in the form of a negative (or positive) shift in public opinion in response to a precautionary IMF arrangement.

## What can and should the IMF do to encourage greater utilization of the FCL and PLL?

Providing extended opportunities for liquidity insurance to its members is clearly in the IMF's own interest, as the warden of global financial stability in an increasingly volatile global environment. A greater number of emerging economies with access to precautionary lending would make the system more stable, particularly if even a limited increase in countries with access created positive spillovers for non-access countries.

Given the three critical concerns listed above, we believe that the IMF ought to take visible steps to demonstrate its commitment to providing immediate, 'no strings attached' resources and encourage more actively the uptake of these precautionary instruments by its member states.

## We have three suggestions:

1. **Improve the transparency and predictability of the qualification assessment**. Since the launch of the IMF's two new precautionary credit lines, the need for more predictability in determining access and for clearer and non-arbitrary determinants of pre-qualification has been evident. Greater transparency and predictability of the qualification assessment was the most important concern suggested by emerging economies for both instruments in the IMF's survey of emerging and small advanced economies. To address concerns regarding country eligibility, the IMF could clarify which of the nine (FCL) or five (PLL) policy areas it assigns the greatest weights to and/or define a smaller subset of relevant indicators. Clarifying the institutional requirements for qualification would be particularly beneficial given the difficulties in finding objective, accurate, comparable indicators of institutional quality. Currently, the only two indicators listed by the IMF in connection with the assessment of the strength of a country's institutional policy framework are "policy cyclicality" and "effective response to shocks," and these are described as "complements" to the assessment, rather than as core components. All new guidance on the qualification criteria should be made public and the IMF should work to bring them to the attention of policymakers—for instance, during regular Article IV consultations. Announcing the publication of a new, easier-to-interpret list of FCL and PLL eligibility criteria or 'assessment guide' could also address potential concerns about the availability of IMF resources for precautionary finance. If there were no resources to provide additional credit lines, it would not make sense to invest in or to publicize such a product.

2. **Consider making qualification for precautionary finance the 'default.'** In a more radical move, as proposed by Panizza and also recommended in a report of the CLAAF group[3] of former finance and central bank officials from Latin America, the IMF could make qualification the default when it comes to precautionary credit. Loss of eligibility due to insufficient policy or economic fundamentals could be shared privately by management with member states every six months or with some other Board-agreed periodicity. If all members were in principle pre-approved, the uncertainty over the outcome of an application and over the IMF's willingness to lend as well as any political stigma associated with the current application process could be eliminated.

3. **Strengthen and disseminate more broadly existing analysis on the positive economic impacts and absence of criticism of governments that have access now. In particular, devote more time and resources to research on public perceptions towards the Fund**. Governments' concerns about political stigma may well persist, despite the extensive reforms in the IMF in governance and interactions with borrowing members over the last 10 years. The issue is one the IMF itself has long grappled with: the stigma issue was discussed at length in several recent reviews and was a central concern as far back as the early 2000s when the IMF introduced its first contingent credit lines. While there is no quick fix, more information in the public domain about the new credit lines, including their lack of any negative market repercussion for currently participating countries, would be a useful step. More analysis regarding the (potential) positive effects associated with access to the FCL or PLL could contribute to reducing the number of unknowns and make the 'risk' of a request for a precautionary arrangement clearer. More in-depth (informal) conversations about the perceived political stigma between policymakers and the IMF staff—particularly in the Asia region, given the fraught history of the Fund's engagement there—could help reduce policymakers' wariness regarding the use of the precautionary credit lines. A new, broader survey of public perceptions towards the IMF could also be useful in understanding any continuing basis for the stigma problem and in formulating strategies to address the problem where needed.

Finally, we note that an effort by the IMF to take any of the above steps that results in a successful application from even one additional country could make a large difference, since each new precautionary arrangement is likely to encourage other potential applicants to consider the benefits and apply—a positive spillover for products with intrinsic global spillover benefits.

## Endnotes

[1] Its predecessor, the Precautionary Credit Line (PCL) was introduced in August 2010

[2] Though qualifying member states can opt for immediate withdrawal of funds as soon as the FCL/PLL arrangement is concluded

[3] Comité Latinoamericano de Asuntos Financieros