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Questions: Mr. Kim, SPR (ext. 34916)
Ms. Turk, SPR (ext. 37706)
Ms. Thornton, FIN (ext. 34464)
Ms. Rosenberg, LEG (ext. 37790)



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ENHANCING THE FUND'S FINANCIAL ENGAGEMENT WITH FRAGILE AND CONFLICT-AFFECTED STATES—STAFF PROPOSALS

EXECUTIVE SUMMARY

This paper presents proposals and options for Directors' consideration to enhance the Fund's toolkit for financial engagement with fragile and conflict-affected states (FCS) by:

- Making full use of existing flexibilities in the current lending toolkit to improve program design, including through more realistic macroeconomic frameworks and streamlined conditionality tailored to the specific situation of each FCS; and
- Enhancing agility of the toolkit through targeted enhancements for shorter term financial engagement preparing the ground for successful medium-term engagement, by combining rapid financing with track record support as well as options to assist members seeking shorter arrangements under the Extended Credit Facility (ECF).

Program design can be strengthened through realistic macro frameworks and tailored conditionality, which can be achieved by:

- Developing clearer operational guidance building on lessons from experience in FCS programs over the past 10 years, with consideration of the political economy context and reliance on the country engagement strategy to prioritize and sequence reforms that foster inclusive and sustainable growth.
- Ensuring realistic macroeconomic frameworks through further guidance and realism tools and by recognizing more explicitly, for programs under the ECF, the possibility of post-program financing gaps in cases where BoP problems cannot be resolved within the program period, and where capacity to repay remains adequate and debt continues to be sustainable under conservative financing assumptions.
- Using floating tranches for the implementation of selected structural reforms, in cases where the authorities are committed to a measure but cannot pin down the time needed to garner support, build capacity, and adopt legislation and regulations.
- Making greater use of indicative targets (ITs) in the initial stage of a program, along with performance criteria (PCs) for critical variables, in cases of limited capacity for accurate data reporting but where ITs would be replaced gradually by more PCs.

Well-designed Fund financial and non-financial engagement can help catalyze more concessional funding. By laying the foundations for reforms, promoting sustainable policies, and helping the member develop institutions needed for macroeconomic stability, the Fund's engagement provides the donor community with a degree of assurance that their financial support including grants would be used effectively.

Greater use of concurrent Staff Monitored Programs (SMPs) and repeat emergency financing could help smooth the transition to a UCT-quality program. Combining rapid financing (where a country cannot implement a UCT-quality program but faces an urgent BoP need) with track record support (e.g., through SMPs) can provide policy support and low-access financing, serving as a bridge to a multi-year engagement. Updated operational guidance would be prepared on the concurrent use of repeat Rapid Credit Facility (RCF)/Rapid Financing Instrument (RFI) and SMPs. On the RCF, staff proposes targeted modifications, keeping its design fundamentally unchanged.

Introducing some flexibility to assist members seeking shorter-term UCT-quality programs would enhance the agility of the toolkit, better catering to the heterogeneous needs of FCS across countries and time, though the risks would need to be carefully considered. Guided by a long-term engagement strategy, the Fund will need to engage with low-income FCS facing protracted BoP problems using a range of instruments. While the standard instrument for low-income FCS facing protracted BoP problems should remain the 3 to 5 year ECF arrangement, there may be circumstances where a shorter arrangement under the ECF would help achieve good progress towards a stable and sustainable macroeconomic position. Staff outlines options including making more effective use of the existing flexibility under the ECF, and introducing a new window for shorter-term arrangements under the ECF.

Approved By
Ceyla
Pazarbasioglu,
Bernard Lauwers,
Rhoda Weeks-
Brown

Prepared by the Strategy, Policy, and Review Department, Finance Department, and the Legal Department. The team was led by Guillaume Chabert, Gavin Gray (SPR), Craig Beaumont (FIN), and Yan Liu, Bernhard Steinki, Gabriela Rosenberg (LEG), and comprised Daehaeng Kim, Tomohide Mineyama, Francisco Parodi, Rima Turk, and Jiangyan Yu (SPR); Joe Thornton, Beata Jajko, Tetsuya Konuki, Karmen Naidoo, Nelson Sobrinho, Marta Spinella (FIN); and Ioana Luca, Gomiluk Otokwala, Jonathan Pampolina (LEG). Additional guidance was provided by Christian Mumssen (FIN). Chiara Castrovillari and Xiaoya Yue (SPR) provided research assistance. Merceditas San Pedro-Pribram and Phyo Zin (SPR) provided administrative support.

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INTRODUCTION

1. **Efforts to enhance the Fund's toolkit for financial engagement with FCS are an important element of broader work to develop a new FCS strategy.** The Fund plays a unique and essential role in fragile and conflict-affected states (FCS), helping members restore macroeconomic stability, build core macroeconomic policy institutions, and catalyze donor support.¹ However, while Fund financial support for FCS has been extensive over the years, the share of successful arrangements was lower with FCS than with other countries.² The 2018 IEO report found that the Fund's financial toolkit, with its relatively short-term focus, is not inherently well suited to the circumstances of fragile states, and noted that the application of conditionality seemed to have differed little for FCS from that applied to other countries. The 2018 IEO report also suggested that there was a gap between (i) emergency financing (EF) instruments designed for rapid financial support—with limited conditions—and (ii) facilities for more sustained and longer support—with much higher policy standards (Upper Credit Tranche (UCT) quality programs). Against this backdrop, efforts to develop a new Fund's strategy for engagement with FCS called for better catering for the specificities of the heterogeneous group of FCS, including through assessing the lending framework to ensure that it is fit for purpose.

2. **The Fund's financial engagement with low-income FCS has been supported by wide-ranging reforms to the Fund's LIC facilities in recent years.** Normal access limits under the PRGT have nearly doubled since 2018,³ and previous caps on exceptional access have been removed. The 2018-19 comprehensive review of the PRGT's lending framework approved targeted increases in access under emergency financing (EF) instruments to accommodate the special circumstances of FCS, and it endorsed the use of flexibility under the Extended Credit Facility (ECF) to enable FCS to focus on near-term program objectives in response to the IEO's findings. PRGT-eligible FCS will also benefit from the package of policy reforms for concessional financing approved in July 2021 to ensure that the Fund can support the financing needs of LICs more flexibly during the pandemic and recovery.

3. **Staff sought guidance from Executive Directors on the direction for FCS lending policy reforms in an informal engagement in October 2021.** Drawing on lessons from past engagement and earlier recommendations from the IEO, staff identified possible improvements in Fund lending to FCS in three areas: better tailoring program design and conditionality, enhancing the agility of the lending toolkit, and improving financing terms where needed. Staff also presented options to enhance the lending toolkit, ranging from those that could be implemented while keeping the

¹ IEO evaluation report 2018, "[The IMF and Fragile States](#)."

² This poor performance—characterized as fewer completion of programs and more frequently going off-track—is also rooted in the various challenges that FCS face, including higher incidence of conflict and natural disaster, political instability, weak institutions, and inherent difficulty in developing macroeconomic projections.

³ The normal access limits were increased from 75/225 percent of quota (annual/cumulative) to 100/300 percent of quota in June 2019, and subsequently to 145/435 percent of quota in July 2021, while the annual access limit was increased on a temporary basis to 245 percent of quota until end-2021.

current lending architecture broadly unchanged to those entailing more fundamental changes to the lending architecture. The potential benefits and challenges associated with each reform option were also presented to the Board.

4. **Directors agreed on the importance of enhancing the toolkit for financial engagement with FCS, with varying degrees of support for the possible options.** There was very broad support for better tailoring program design and conditionality in line with the earlier IEO recommendation, while ensuring that programs with FCS are ambitious enough to restore macroeconomic stability and external viability, helping to exit from fragility. Directors were also generally open to the options to improve the agility of the lending toolkit, while calling for further clarification on specific design features of these options. Lastly, it was noted that FCS could benefit from longer maturity financial assistance under the Resilience and Sustainability Trust (RST) (see Box 1).

Box 1. The Resilience and Sustainability Trust

The Resilience and Sustainability Trust (RST) for which parallel work is ongoing aims to offer LICs, small states, and vulnerable middle-income countries longer-term financing to foster resilient and sustainable growth. FCS would be able to request RST financing provided that they meet the qualification criteria. The RST would help them address long-term structural challenges, such as climate change. These issues, if left unaddressed, could adversely impact balance of payments stability in the future. Maturities would be up to 20 years—longer than currently available under the PRGT and GRA facilities—and financial costs of RST financing would be lower than that of the GRA resources.

Staff is advancing work on the design and financial structure of the RST. Staff aims to reach agreement on the RST design by the 2022 Spring Meetings. Subject to contributions, the Trust could be fully operational around the time of the 2022 Annual Meetings.

5. **In light of this guidance, this paper presents a focused set of specific proposals and options for Directors' consideration.** Staff proposes two complementary channels to enhance the Fund's long-term engagement with FCS.

- First, for FCS that are able to successfully implement medium-term UCT programs, staff proposes to make full use of the existing flexibility in the current lending toolkit to improve program design, including through more realistic macroeconomic frameworks and streamlined conditionality tailored to the specific situation of each FCS and building on the analysis of the drivers of fragility. Such approach would help better design IMF-supported programs that support ambitious reforms implemented by members to progressively advance their exit from fragility.
- Second, staff proposes targeted enhancements to the toolkit to help members prepare the ground for a successful medium-term engagement. The paper proposes to: (i) make greater use of concurrent Staff Monitored Programs (SMPs) and low-access financing through Rapid Credit facility (RCF) and/or Rapid Financing Instrument (RFI); and (ii) develop options to better support members that are unable to commit to a fully-fledged ECF-supported program, including by

using the existing flexibility under the ECF or by introducing a new window for shorter-term ECF arrangements.

6. **Fund engagement with FCS should continue to be carefully balanced with the need to safeguard Fund resources and countries' debt sustainability.** Fund financial engagement with FCS inherently carries greater financial risk given their circumstances. Continuing to ensure that adequate safeguards are in place—including through appropriate program design and conditionality, debt sustainability analysis (DSA) and capacity to repay (CtR) assessment—is thus of utmost importance.

7. **The remainder of the paper is organized as follows.** Section II discusses staff's plan to strengthen program design and streamline conditionality. Section III identifies ways to better leverage the Fund's engagement to help FCS mobilize grants. Section IV discusses staff's proposal for making greater use, where appropriate, of concurrent SMPs and repeated RCF/RFI, and the need for related targeted modifications to the RCF. Section V considers options for short-term UCT engagement with PRGT-eligible members with protracted BoP needs. Section VI concludes with issues for discussion. Staff will incorporate further guidance from Directors on these proposals in another paper for the Board to indicate a final decision on the options to be adopted, tentatively scheduled for the first quarter of 2022.

STRENGTHEN PROGRAM DESIGN THROUGH REALISTIC MACRO FRAMEWORKS AND TAILORED CONDITIONALITY

8. **The Fund's principal mode of financial engagement with FCS is through medium-term UCT-quality programs.** In particular, for FCS with protracted BoP problems, which is the typical situation for LIC FCS, programs supported by 3–5-year ECF arrangements are and should remain the principal instrument/mode of Fund's financial engagement wherever possible.

9. **Careful tailoring of program design coupled with streamlined and parsimonious conditionality are vital to ensure that UCT quality programs for FCS focus on the most important and impactful measures.**⁴ Including lower priority goals can distract country authorities with limited capacity operating in a complex social-political environment. Arrangements with FCS, like for all other members, should be ambitious to achieve or restore macro stability and address underlying structural challenges. The streamlining of conditionality in the face of the challenges associated with fragility and conflict should not compromise the strength of the UCT-standard of reforms—on the contrary, it helps promote ambitious programs by focusing the member's limited capacity and integrated capacity development (CD) activities on the most critical measures. Overall,

⁴ These would be measures that foster macroeconomic stability, and help the member solve its BOP problems and achieve medium-term external viability while fostering sustainable economic growth.

the focus should be on prioritizing the policy agenda, guided by the country engagement strategy, and anchored in a realistic macroeconomic framework.

10. **Clearer guidance is needed to achieve these goals.** The context is that review completion rates have been much lower in fragile states than in other countries (2018 Review of Conditionality), most often due to adverse political developments (e.g., military coups), underscoring the intrinsic riskiness of engagement with FCS.⁵ In some cases, members may not be ready for UCT quality engagement. For those that are, it is vital that the Fund supports those members with appropriately designed programs or conditionality. While the 2012 guidance note stressed the need for realism, parsimony and realism were not always fully implemented.⁶ More recent evidence, based on programs approved since 2016 suggests gradual moves towards greater parsimony. Against this backdrop, staff proposes to develop clearer operational guidance to ensure better tailored program design and streamlined conditionality for Fund-supported programs for FCS as part of a new guidance note on the Fund's engagement with FCS.⁷ The new guidance would be incorporated into the Fund's Internal Economics Training (IET) program to enhance staff's capacity to engage with FCS, while training would also be offered to the country authorities as needed.

Conditionality

11. **Grounded in the core principles of IMF program engagement, the updated guidance for Fund's financial engagement with FCS should reflect concrete lessons learned from practical experience.** The guidance will need to remain consistent with the 2002 Board-endorsed [Guidelines on Conditionality](#),⁸ and its principles should continue to reflect and build on those included in the 2012 staff [guidance note](#) on Fund's engagement with FCS, which are as follows and remain valid: (i) explicit consideration of the political context; (ii) a well-tailored pace of macroeconomic adjustment; (iii) opportunities for "quick wins"; (iv) emphasis on inclusive growth and social protection; (v) well-tailored structural reforms; (vi) integrated CD activities; and (vii) contingency planning. The updated guidance, however, should closely build on the FCS strategy and

⁵ Staff analysis found that only about 45 percent of LIC FCS Fund-supported programs completed all reviews, compared with almost three-quarters for the peer group of non-FCS LICs, while 31 percent of LIC FCS programs (9 programs) went off-track, compared with 10 percent for the peer group (3 programs).⁶ The 2018 Review of Conditionality notes that a higher proportion of programs with FCS went off track which suggested that programs may have been hampered by an excessively expansive agenda, which failed to adequately reflect low capacity and specific sources of fragility (2018 ROC, paragraph 62).

⁶ The 2018 Review of Conditionality notes that a higher proportion of programs with FCS went off track which suggested that programs may have been hampered by an excessively expansive agenda, which failed to adequately reflect low capacity and specific sources of fragility (2018 ROC, paragraph 62).

⁷ The new guidance will be part of the comprehensive Staff Guidance Note on the Implementation of the FCS Strategy, which will cover all forms of engagement with FCS including financial engagement and will supersede the 2012 Staff Guidance Note on the Fund's Engagement with Countries in Fragile (SM/12/92). It would also support strengthening collaboration and information sharing among FCS teams to create a pool of real-time knowledge that could help design engagement strategies and programs.

⁸ The [Guidelines on Conditionality](#) establishes five key principles that should guide the design and setting of conditionality: national ownership of programs, parsimony in program-related conditions, tailoring to country circumstances, coordination with other multilateral institutions, and clarity in the specification of conditions.

be more concrete and more operational than the 2012 guidance note, which remained high level and difficult to implement, in particular, given the lack of concrete examples.⁹ It should also incorporate the 2018 Strengthened Framework on Governance, calling for greater candor when corruption is identified as being macro-critical and greater outcome orientation of recommendations to improve governance and integrity. The updated guidance should build on the findings of the 2018 IEO report and 2018 Review of Conditionality, as well as on the lessons drawn from practical experience in FCS programs over the past 10 years, including during the pandemic period, with a view to equipping country teams and reviewers with a greater practical sense of “what works and what doesn’t.” It should also reflect the experience of international partners, where relevant to the Fund’s mandate.

12. The updated operational guidance would aim to ensure that programs for FCS are well tailored to country circumstances and that structural reforms are adequately sequenced.

Program design and conditionality should closely follow the principles of parsimony, and criticality to all program-related conditions and national ownership of reform programs, paying due regard to domestic social and political objectives, economic priorities, and country-specific circumstances.¹⁰ Criticality for achieving program objectives is the first and foremost consideration that guides the scope and content of the structural reform agenda. Additional considerations in the design and sequencing of structural reforms include capacity to implement reforms, national ownership, reform momentum under the existing or recently concluded program, reforms’ impact on the economic recovery, and inequality and governance considerations.

13. The Country Engagement Strategy (CES) should help guide the prioritization and sequencing of structural reforms in FCS. The CES, serving as a high-level longer-term strategic anchor for the Fund’s engagement with FCS, should inform decisions on program design and conditionality, with regards to country-specific drivers of fragility, institutional constraints on reform implementation, and political economy considerations and identification of the main risks to Fund engagement. It will contribute to better tailored policy advice, financial support, and capacity building, helping align program objectives with the medium- and long-term reform agenda for the FCS, considering the criticality of the measures to achieve program objectives and the Fund’s areas of competence.

14. Program design and conditionality for FCS should make appropriate use of existing flexibility, mindful of applicable conditionality standards, to better reflect the limited implementation capacity in most FCS. With regards to parsimony of conditionality, the guidance note would recall that medium-term reform agenda items that are not critical to program success

⁹ The 2012 Staff Guidance Note reflects the Board discussion of Macroeconomic and Operational Challenges in Countries in Fragile Situations (SM/11/122).

¹⁰ In considering the Fund’s engagement with countries in fragile situations, Directors “generally welcomed the call for greater flexibility in program design to better reflect the limited implementation capacity in states in fragile situations” but also “underlined that the conditionality standards applicable to different financing facilities should be maintained” (BUFF/11/102, The Chairman’s Summing up On Macroeconomic and Operational Challenges in Countries in Fragile Situations).

should be expressed as commitments under the Memorandum of Economic and Financial Policies (MEFP) rather than structural benchmarks (SBs). Based on concrete examples where possible, the guidance note will also underscore that program focus and targets should be adapted to evolving country circumstances, including through program reviews. To help anchor program policies, program design should anticipate the reaction to shocks in case they materialize, placing authorities in a stronger position to consider a range of options in a timely manner. The potential for entrenched forces to resist reform so they can preserve their rents should be considered. In designing conditionality, while being mindful of applicable conditionality standards, staff should assess the authorities' capacity to provide required data or implement prior actions which will reduce the risk of misreporting. Staff plans to provide also further guidance on underutilized flexibility in the existing lending toolkit, such as post-program financing gaps, floating tranches, and indicative targets, which would contribute to a more robust macro framework and realistic program targets.

15. **Several specific features of FCS should be taken into account in tailoring program design and developing conditionality for UCT programs.** First, program measures and associated conditionality should fully consider the political economy context, analysis of macro-critical manifestations of fragility and carefully prioritize policies that protect social outcomes to foster inclusive and sustainable growth. Thus, program design should reflect the Fund's strategy on social spending.¹¹ Second, given the multi-dimensional nature of risks, programs should be designed with alternative strategies that could be activated if shocks materialize, while monitoring possible unintended consequences of the authorities' programs.

Realistic Macroeconomic Frameworks and Post-Program Financing Gaps

16. **A realistic macroeconomic framework—including prudent assumptions about the evolution of growth, revenues, financing, and payoffs from structural reforms—is a precondition for good program design.** The revised guidance will establish the need for a macroeconomic framework which properly reflects the structure of the economy (e.g., lack of diversification) and internalizes implementation capacity constraints and the risk of reform reversal. Departures from historical growth rates, for example, will need to be fully justified, while the impact of periodic shocks will need to be built into baseline growth rates for the DSA. Likewise, yields from longer term structural reforms need to be carefully projected and phased to avoid overestimating their impact on fundamentals in the shorter term. Staff will develop further guidance and realism tools to support more robust macroeconomic frameworks and program design.

¹¹ In this regard, staff should apply the key conclusions of [the Fund's strategy on social spending](#).

17. **Programs should avoid overly-optimistic assumptions that BoP problems would be resolved within the program period in cases where this is not feasible.**¹² In this context, post-program financing gaps, in the form of unidentified financing in the years immediately after the end of the program, can be considered to the extent that such gaps are consistent with lending requirements including debt sustainability and capacity to repay the Fund (CtR). A more explicit recognition of PPFs would help ensure more realistic macro frameworks and reform agendas in FCS programs under the ECF.¹³ Optimistic assumptions that BoP problems should be fully resolved within the program period would lead to overly ambitious targets, potentially resulting in higher failure rate and weaker ownership of the program.

18. **Recognizing more explicitly the existence of PPFs should be accompanied by appropriate safeguards.** The presence of PPFs and uncertainty on how they would be filled could potentially complicate CtR and debt sustainability assessments. Therefore, it would be important to identify risks to the medium-term viability of a country with PPFs, provide early warnings on risks to the Fund's balance sheets, and assess the robustness of adequate CtR and debt sustainability in the face of such risks. PPFs can be justified when the sensitivity analysis confirms that CtR remains adequate and debt remains sustainable under realistic financing assumptions (including level of funding on non-concessional terms) to close the PPFs (Box 2). In addition, any program documents should include a detailed discussion on availability of financing sources other than the Fund, Fund catalytic role and the extent of Fund burden sharing. This discussion will also play an important role in the overall risk assessment.

Floating Tranches (FTs)

19. **Well-designed FTs can give the authorities greater flexibility in setting the timetable for implementing selected structural reforms, thereby likely enhancing ownership** (See Box 3). FTs are defined as purchases or disbursements whose availability is contingent on the implementation of specific measure(s) that meet certain requirements, rather than being tied to a fixed Board review schedule.¹⁴ An appropriate use of FTs would help avoid delays in program implementation where an upfront commitment on specific timing is undesirable or unfeasible given capacity constraints and fluid social, political and economic situations. FTs could complement other

¹² In case of programs supported by the GRA, the policy measures aimed at resolving a member's BoP problem should be undertaken during the program period, and the policies must be implemented in a manner that will lead to a strengthening of the member's BoP before repurchases begin. However, there is some flexibility in the ECF under the PRGT because of the protracted nature of the BoP problem. In such cases, the resolution of underlying macroeconomic imbalances needed to establish a stable and sustainable macroeconomic position would be expected to extend over normally three years or more, and in any case more than two years (FO/DIS/21/134, footnote 16).

¹³ The explicit recognition of PPFs would apply to all PRGT-eligible members.

¹⁴ Formally, the member can draw the purchases once management has determined that the reform has been implemented, provided that the program is on track. The new guidance would apply to FCS and non-FCS alike.

forms of conditionality to monitor structural reforms (e.g., prior actions and structural benchmarks) without eroding the overall strength of the program or safeguards, or undermining the principle of parsimony.

Box 2. Assessment of CtR and DSA in the Presence of PPFs

CtR and debt sustainability assessments could be guided by the following principles:

- **Criteria for assessing debt sustainability and CtR in the presence of PPFs.** The following criteria can be used to assess whether debt is sustainable in the presence of PPFs: (i) the financing assumptions to fill the gaps and related risks should be realistic (see below); (ii) under realistic assumptions on financing terms, the magnitude of the PPFs should not lead to significant and protracted breaches of DSA indicators from applicable DSA thresholds^{1/}; (iii) for exceptional access, the country must meet the relevant exceptional access policy conditions and criteria even in the presence of the PPFs; (iv) closing PPFs should not give rise to arrears or undue adjustment, and PPFs should be narrowing over time relative to the size of the economy; and (v) the risk of further financing gaps in the future is contained.
- **Sensitivity analysis.** CtR and debt sustainability should be rigorously assessed both under baseline financing assumptions and under alternative scenarios that PPFs-related risks are realized. Some risks include less policy adjustment and/or more unfavorable financing terms than in the baseline in the post-program period. CtR and debt sustainability analyses critically depend on the assumptions by country teams on financing terms and the outlook of other macroeconomic variables. Therefore, staff should explore in depth how the PPFs are closed under various scenarios and analyze the ensuing impact on the CtR and debt sustainability if risks associated with the unidentified financing materialize.
- **Post-program assumptions.** Financing to close PPFs should exclude optimistic gap-closing financing items and financing assumptions on a Fund successor arrangement. Also, given the fragilities of FCS, any assumptions in the sensitivity analysis involving increasing levels of foreign grants, rising domestic financing, large policy adjustment and stronger growth after the program period should be thoroughly justified. The post-program projections should be based on realistic assumptions on how to close the gap (i.e., the adjustment and financing mix, and terms of additional financing) and its growth impact. As a standard DSA requirement, the potential risks from data gaps should be discussed and options for filling them should be a focus of team discussions with country authorities.

^{1/} A significant or sustained breach of DSA thresholds could occur when one or more debt burden indicators are continually rising and above threshold as the forecast horizon advances; when the breaches meet or exceed five years; the timing of the breach happens within the first five years of the projection; how quickly near-term breaches begin to be reversed; and whether the breaches cover both debt solvency and liquidity indicators (see [Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-Income Countries](#)).

20. **Staff intends to prepare operational guidance on the circumstances in which FTs could be used, and how they can be integrated into UCT-quality programs.** The identification of policies supported by floating tranches should reflect country-specific circumstances. Examples could include measures such as social reforms, transformation of monetary/FX regime or trade liberalization in situations where the authorities are committed to the measure but cannot pin down the exact time needed to garner broad support, build capacity and adopt legislation and regulations. Floating Tranches also raise operational issues that will have to be resolved, including

the need for clear procedural requirements for the approval of the disbursement of specific FTs to mitigate disbursement risks, the implications for capacity to repay projections, and, for the GRA, the calculation of commitment fees.¹⁵

Box 3. Floating Tranches: Summary of Existing Guidance, and Scope for Further Clarification

Floating Tranches were introduced into the Fund's toolkit two decades ago. They were proposed in the [2002 Review of Conditionality](#), with the aim of providing greater flexibility on the timing of implementation of certain policy measures and thus fostering stronger ownership.¹ At the time, staff noted that such conditionality (and associated disbursements) have been adopted by the World Bank, including in the context of Higher Impact Adjustment Lending (HIAL), with generally positive results. Subsequently, FT were incorporated into the [Guidelines on Conditionality in 2002](#) and further elaborated on in the [2005 Review of Conditionality](#). While the tool has not been applied so far, there have been various precursors with a "floating" character such as the Fund's Debt and Debt Service Reduction (DDSR) policy and the enhanced Heavily Indebted Poor Countries (HIPC) Initiative with release of financing or debt relief linked to achievement of specific targets.

FT are released once the associated measures have been implemented. FTs are purchases or disbursements where their availability is "contingent on implementation of a specific measure or measures, which has no fixed date attached" (see figure below). The specific measure and access would typically be decided at the approval of an arrangement, with the Board approving the commitment of the FT ex-ante. The disbursement under the FT would then be released upon approval by management on staff recommendation that the associated reform has been completed. The disbursement can be made available only if the program is on track.



To ensure appropriate application of FT, a range of conditions need to be met:

- There is some unavoidable *uncertainty* about the timing of the measure, or an upfront commitment on specific timing is not desirable, e.g., due to implementation not being required for immediate external stabilization or where implementation depends on other factors such as international agreements, which are difficult to project.
- Measures attached to the FT need to *strengthen the external position* in the medium term, so as to warrant the release of additional Fund resources, while *increasing the BoP need in the short term*.
- Policies linked to the fixed-tranche macroeconomic component would need to constitute a viable, albeit not first-best, program even if the policies linked to FTs were not implemented. Thus, measures associated with a FT should *not be required for immediate external stabilization*, but they still need to be *critical to achieving other program objectives*.

¹⁵ The use of FTs may have a direct impact on the calculation and timing of commitment fees, especially if a portion of the borrowing member access is linked to future reforms. Currently the Fund bills every year based on the scheduled purchases in the next 12 months. However, the concept of FTs may make it difficult to calculate commitment fees, project income from charges, estimate capacity to repay and reliably estimate demand for GRA resources in the context of the FTP. Further clarification would be needed on (i) how GRA commitment fees should be calculated with respect to a floating tranche; (ii) how FTs should be incorporated into capacity to repay projections; and (iii) how FTs should be reflected in estimated demand for Fund resources as part of the FTP survey.

Box 3. Floating Tranches: Summary of Existing Guidance, and Scope for Further Clarification (concluded)

- Measures need to be *consistent with resolving BoP problems, macroeconomic stability, and other program goals.*

Careful consideration is needed as to whether a measure is more suited for a SB or FT. Structural Benchmarks would generally be more suited for measures that are required for immediate external stabilization or where sequencing of multiple reforms is important. Use of a Floating Tranche could help decouple the implementation of the macro-stabilization program (fixed-tranche component) from specific reforms required for longer-term external sustainability and growth (Floating Tranche component).

^{1/} See also [Khan and Sharma \(2001\)](#) on ownership and Floating Tranches.

Indicative Targets (ITs)

21. **Heightened uncertainty and limited capacity can justify greater use of indicative targets (ITs) under certain circumstances.** Fund-supported programs should include the standard QPCs on macroeconomic indicators deemed key to meeting the program targets, such as the fiscal balance, net international reserve (NIR), and Net Domestic Asset (NDA). Facing large uncertainty, however, staff and the authorities sometimes find it difficult to predict the evolution of macroeconomic aggregates and set quantitative targets to anchor policy actions in the short term. Meanwhile, limited capacity could complicate accurate data reporting, increasing the risk of delays or misreporting on quantitative targets. In these cases, and subject to meeting requirements under existing lending instruments, greater use of ITs might be justified in the initial stage of a program, while the use of ITs would be replaced gradually by more quantitative performance criteria as the program implementation helps stabilize the macroeconomic situation and build capacity over time.¹⁶ This will need to be carefully analyzed on a case-by-case basis and clear justification should be presented in program documents.

22. **Greater use of ITs in the initial stages of the program, together with PC for critical variables, does not imply a loosening of UCT standards.** The quantified macro framework would need to meet the UCT standards of Fund-supported programs. Performance relative to the program macro framework would continue to inform the Board's decision to complete a review, based on a comprehensive assessment of whether the objectives of the program remain on track, considering observance of quantitative targets and prospective policies. In case of substantial deviations from

¹⁶ Where lending instruments require inclusion of PC, the program will observe existing policy requirements (e.g., under the ECF policy, disbursements shall be phased at regular intervals [...] "with *performance criteria* applicable specifically to each disbursement ..."

program targets (including ITs) and a lack of sufficient corrective actions to ensure the program remains valid and is on track to meet its objectives, staff and management are still called upon not to propose completion of a review.

LEVERAGING MORE FUND ENGAGEMENT AND PARTNERSHIPS TO HELP RAISE GRANTS

23. **Fund engagement, and in particular Fund-supported programs, can play an important catalytic role.** The IEO report underlined the catalytic role of Fund engagement and programs in mobilizing financial support from other development partners. Both bilateral and multilateral partners often consider IMF economic assessment (through surveillance and/or policy advice), capacity development activities, and/or financial (financing arrangements and outright purchases/disbursements) or non-financial (SMPs) engagement as an important factor for their own financial engagement.¹⁷

24. **Fund's financial and non-financial engagement can help catalyze more concessional funding by creating the foundations for reforms and institutional change, promoting sustainable policies and the core institutions needed for macroeconomic stability.** Fund engagement provides the donor community with a degree of assurance that their financial support would be used effectively, taking benefit of a more transparent and more sustainable macroeconomic framework. In particular, the Fund's commitment to provide capacity development and policy support, and to regularly oversee progress under the economic adjustment program, are a critical point of reference for other donors, signaling that public finances and the broader policy framework are benefitting from the Fund's guidance and monitoring.

25. **Well-designed Fund financial and non-financial engagement, coupled with stronger cooperation among partners, can, in principle, help enhance the international community's support to FCS, including through grants.** First, the Fund's financial and non-financial engagement should foster closer coordination with multilateral and bilateral donors, engaging with donors on focused prioritized reforms, to help unlock additional financing and grants.¹⁸ Second, an integrated approach to surveillance, lending, and capacity development informed by the CES could help garner further support from donors to FCS. Third, use of SMPs, coupled with financing under the RCF/RFI where appropriate, could strengthen signaling effects and the catalytic role of Fund

¹⁷ The IEO's analysis provides evidence showing that IMF arrangement have typically been associated with a marked increase in donor support to FCS.

¹⁸ While Fund's engagement must continue to focus on the Fund's core mandate, collaboration with multilateral and bilateral partners would help support reform measures that are critical for achieving goals such as improving inclusivity, broad-based development and welfare.

engagement in circumstances when a UCT-quality program is not feasible. Last, Fund efforts on capacity development would help improve FCS resilience, strengthening their ability to raise grants and concessional financing.

26. **As part of the new FCS Strategy, staff will monitor the evolution of the catalytical impact of Fund's engagement with FCS.**

COMBINED RAPID FINANCING AND TRACK RECORD SUPPORT

27. **In situations where an FCS is not yet able to implement a UCT-quality arrangement, Fund staff can provide support through an SMP and, if there are urgent BoP needs, the Fund can provide RCF/RFI support.** SMPs are often used by FCS to build a track record toward a UCT-quality program, although the actual shift to such programs has been limited in the past.¹⁹ Experience has shown that FCS often need extended time as well as some financing and integrated CD activities to advance track-record building reforms. The Board has expressed a preference for the use of SMPs when a member needs to establish a track record of adequate macroeconomic policies, and noted that an assessment of policy commitments made in the context of disbursements under the RCF could also be used for that purpose.²⁰

28. **The RCF and RFI are flexible tools that can provide low-access financing to countries facing urgent BoP needs.** The reform of LIC facilities in 2010 created the RCF to provide rapid low-access financial support with limited conditionality, which can be used under a wide range of circumstances where a UCT program is either not needed or not possible. It unified the Fund's preexisting emergency financing tools that provided rapid support after exogenous shocks (including terms of trade shocks or natural disasters) or conflict, and closed a gap in the toolkit for situations of domestic instability, emergencies, or fragility where a country cannot implement a UCT-quality program, but faces an urgent BoP need *not* arising from a specific exogenous shock. While the RCF (and the subsequently created RFI) seems to be well designed for these various purposes, a number of changes, detailed below, could be considered to improve its flexibility, which would help improve the Fund's engagement with FCS.

29. **Greater use of concurrent SMPs and repeated RCF/RFI could help FCS smooth the transition to a UCT-quality program.** There have been only few instances of concurrent use of SMPs with EF thus far.²¹ When FCS face urgent BoP needs while building a track record toward a

¹⁹ The RCF and RFI can also be used to support a transition to a UCT-quality program.

²⁰ BUFF/16/84, the Chairman's Summing Up - Financing for Development: Enhancing the Financial Safety Net for Developing Countries—Further Considerations, Executive Board Meeting 16/103, November 16, 2016.

²¹ To date, there have been five cases by four countries where an SMP and RCF were approved concurrently to help address urgent BoP needs while building a track record toward a UCT-quality program. In these cases, the urgent BoP needs arose from commodity price declines (DRC, Madagascar, and South Sudan) and the Ebola outbreak (The

(continued)

UCT-quality program, lack of financing could force them to undertake excessive macro adjustments, run domestic arrears, or postpone essential reforms. Furthermore, urgent BoP needs in the context of FCS could arise more frequently than for non-FCS members, because the former often face *both* exogenous shocks, such as natural and health disasters and commodity price cycles, *as well as* domestic (political and economic) instability and fragilities (including in near/post-conflict situations). Against this backdrop, the concurrent use of SMPs and repeated RCF/RFI can allow the Fund to provide policy support and low-access financing while building a bridge to a multi-year UCT-quality program.

30. Concurrent use of SMPs and RCFs/RFIs can also help mitigate risks to the Fund associated with standalone disbursements. The RCF/RFI provides rapid assistance for urgent BoP needs without ex post conditionality, which, absent adequate safeguards, could potentially increase credit risk to the Fund and induce opportunistic behavior. Limited conditionality to address urgent BoP needs is in place, in the form of ex-ante policy undertakings outlined in the member's letter of intent (LOI) requesting financing under the RCF or RFI, where the member must set out the policies it plans to pursue to address its BoP difficulties, and its commitment not to introduce measures or policies that would compound these difficulties. Combining SMPs and RCF/RFI can further mitigate these risks by helping countries implement policies aiming at addressing existing vulnerabilities fostering macroeconomic stability. The SMP also provides an opportunity to assess authorities' commitment and progress towards implementing key reforms. In particular, the SMP would help meet the requirements of a track record of adequate macroeconomic policies for repeated use of the RCF/RFI.

31. The current framework already accommodates repeat low-access RCF/RFI disbursements under certain circumstances, including a satisfactory track record. As noted above, the regular window of the RCF covers a broad range of urgent BoP need—i.e., BoP need that, if not addressed, would result in immediate and severe economic disruption—including domestic instability, emergencies, and fragility.²² Indeed, the use of RCF/RFI by FCS in the pre-pandemic period demonstrates various factors causing urgent BoP needs (Table 2). Access under the regular window of the RCF is currently subject to a per disbursement limit of 25 percent of quota (within the annual and cumulative access limits of 50/100 percent of quota), leaving room for repeated disbursements (Table 1). Specifically, repeated use under the regular window of the RCF within a three-year period is possible when the member has established a track record of adequate macroeconomic policies during the six months prior to a second request.²³ The number of RCF

Gambia, two concurrent uses in 2015 and 2017). The concurrent use of SMP and RFI is also possible. In the case of Iraq, the RFI approved in August 2015 was later followed by an SMP, effective from November 2015 to December 2016. See Table 1 in the informal paper discussed at the Board on October 22, 2021 for the details.

²² The exogenous shock window of the RCF and large natural disaster (LND) window of the RCF/RFI are for urgent BoP needs that arise primarily from a sudden exogenous shock (or from a large natural disaster for the LND window). The use of these two windows could also be repeated when a country is hit by a sudden exogenous shock or a large natural disaster, subject to the maximum of two disbursements in a 12-month period in the case of the RCF.

²³ Track record requirements do not apply for a repeat use of the RCF or RFI within a 3-year period where such repeat use is sought to meet an urgent BOP need caused primarily by a sudden and exogenous shock.

requests is capped at two disbursements in any 12-month period.²⁴ Purchases under the RFI are not subject to specific limits on the size of each disbursement or the number of disbursements within a 12-month period, provided that these are within the access limits and the qualification criteria are met.

Table 1. Selected Features of Emergency Financing Under the Current Framework

Emergency Instrument	Window	Annual/cumulative Access limit^{1/ 2/}	Maximum number of disbursements in 12 months^{1/}	Notes
RCF	Regular	50/100	2	A per disbursement limit of 25 percent of quota
	Exogenous shocks	50/150	2	
	Large natural disaster	80/183.33	2	Subject to an assessment that the disaster has caused damage of at least 20 percent of the member's GDP.
RFI	Regular	50/150	No limit provided that conditions are met	No specific per disbursement limit if within access limits.
	Large natural disaster	80/183.33	No limit provided that conditions are met	Subject to an assessment that the disaster has caused damage of at least 20 percent of the member's GDP.

1/ Temporary modifications (except for the access limits under the regular window of the RCF) were introduced in the context of the COVID-19 pandemic and effective until end-2021. The cumulative access limit of 150 percent of quota for the RFI regular window and for the RCF exogenous shocks window, and of 183.33 percent of quota for the large natural disaster windows of the RCF and RFI are in place until June 30, 2023. (SM/21/201) The two-disbursement limit in the number of RCF disbursements within 12 months applies in respect to any repeat use of the RCF, regardless of the window.

2/ Percent of quota. Cumulative limits are net of schedule repurchases and repayments.

²⁴ This cap was temporarily suspended until end 2021 and has since been reinstated (SM/21/201).

Table 2. Non-Covid-19 Pandemic Emergency Financing Since 2010

	Country	Year	Arrangement Type	Total access at approval (in SDR million)	Percent of Quota at approval	Event
Natural and Health Disaster	Guinea	2014	RCF	26.775	25	Ebola outbreak
	Gambia, The	2015	RCF	7.775	25	Ebola outbreak
	Liberia	2015	RCF	32.3	25	Ebola outbreak
	Democratic Republic of the Congo	2019	RCF	266.5	25	Ebola outbreak
	St. Lucia	2011	RCF	3.83	25.03	Hurricane Tomas
	St. Vincent and the Grenadines	2011	RCF	2.075	25	Hurricane Tomas
	St. Vincent and the Grenadines	2011	RCF	1.245	15	Natural disaster
	Dominica	2012	RCF	2.05	25	Natural disaster
	Samoa	2013	RCF	5.8	50	Cyclone Evan
	St. Vincent and the Grenadines	2014	RFI-RCF	4.15	50	Natural disaster
	Dominica	2015	RCF	6.15	75	Tropical Storm Erika
	Nepal	2015	RCF	35.65	50	Earthquake
	Vanuatu	2015	RFI-RCF	17	100	Cyclone
	Ecuador	2016	RFI	261.63	37.5	Earthquake
	Haiti	2016	RCF	30.713	18.75	Hurricane Matthew
	Comoros	2019	RFI-RCF	8.9	50	Tropical Cyclone Kenneth
	Mozambique	2019	RCF	85.2	37.5	Cyclone Idai
St. Vincent and the Grenadines	2021	RCF	8.172	69.85	Volcanic Eruption	
Other Events	Côte d'Ivoire	2011	RCF	81.3	25	Political crisis
	Yemen	2012	RCF	60.875	25	Political crisis
	Mali	2013	RCF	12	12.86	Political crisis
	Kyrgyz Republic	2010	RCF	22.2	25	Political turmoil and ethnic conflict
	Madagascar	2014	RCF	30.55	25	Political instability and disruptions in Exports
	Madagascar	2015	RCF	30.55	25	Political instability and fragility
	Guinea-Bissau	2014	RCF	3.55	25	Political instability and terms of trade shock
	Mali	2013	RCF	10	10.72	Political transition
	Central African Republic	2015	RCF	5.57	10	Political transition and civil war recovery
	Central African Republic	2015	RCF	8.355	15	Political transition and civil war recovery
	Gambia, The	2017	RCF	11.663	18.75	Political transition and terms of trade shock
	Iraq	2015	RFI	891.3	75	Post-conflict
	Central African Republic	2014	RCF	8.355	15	Fragility
Nepal	2010	RCF	28.52	40	Global economic crisis	

32. **In addition to a clearer operational guidance, staff proposes some targeted modifications to the framework to further improve concurrent use, while keeping the fundamental design of the instruments unchanged.** The aim is to improve the agility of the framework and help better tailor its use to country-specific circumstances:

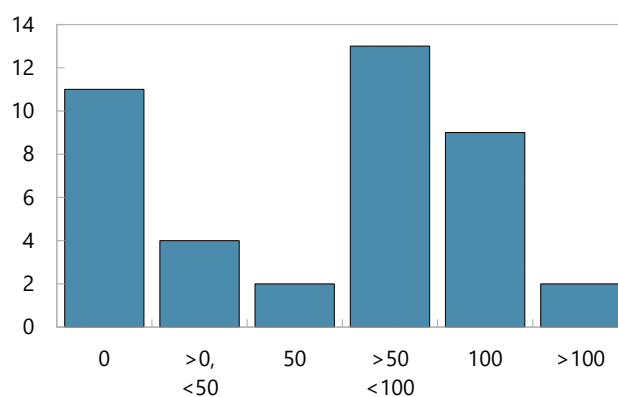
- Umbrella Guidance.** Further operational guidance on the design and merit of the concurrent use of SMPs and repeated RCF/RFI should be elaborated. Providing greater clarity and guidance to country teams and the authorities on its design and merit could foster stronger uptake of this option. Several issues would also benefit from further operational guidance. Specifically, a subsequent RCF/RFI disbursement cannot be pre-committed, as the requests are approved on a stand-alone basis with an assessment of the presence of urgent BoP needs at the time of each request for the RCF/RFI. The RCF or RFI, however, can be used to support a transition to a UCT-quality arrangement, and staff will provide a new umbrella guidance on *Combined Rapid Financing and Track Record Support* that will elaborate on the appropriate combined use of SMPs and RCFs/RFIs. As is the case currently, the assessment of progress against the policy commitments made in the context of disbursements under the RCF could also be used for track record purposes.

- **Flexible timing of RCF disbursements.** Staff proposes to eliminate the cap of two disbursements under the RCF within a 12-month period to accommodate more flexible timing of disbursements and alignment with potential SMP reviews. With the annual access limits (AALs) of the RCF under the exogenous and LND windows having reverted to the pre-pandemic level of respectively 50 and 80 percent of quota (the AAL under the regular window of the RCF remained unchanged throughout the pandemic at 50 percent of quota), the risks from potential multiple disbursements would be mitigated. With the elimination, the RCF will be subject to the same rule as the RFI in this regard.
- **RCF access per disbursements.** Staff proposes to retain a limit on RCF access per disbursement to avoid excessive frontloading of repeated disbursements. To allow for further flexibility in phasing, however, staff proposes to modestly increase the cap of per disbursements under the RCF regular window from 25 percent of quota to 35 percent of quota. The higher per disbursement limit would facilitate more front-loaded emergency support, where necessitated by the BoP needs and the strength of commitments, including when a repeated use is anticipated.
- **RFI-SMP combined use.** To enhance the support for non-LIC FCS, staff also sees merit in clarifying circumstances under which the concurrent use of SMPs and RFIs (including repeated RFIs) could be beneficial.²⁵ Under the current framework, there have been no cases of non-LIC FCS requesting concurrent RFIs and SMPs, although it is already feasible: the regular window of the RFI covers cases of an urgent BoP needs that, if not addressed would result in an immediate and severe economic disruption, and a UCT-quality program is either not feasible or not necessary. Under the RFI policy, if a member has made an RFI purchase within the three preceding years, any additional purchases may be approved only if (i) the urgent BOP need was caused primarily by an exogenous shock, or (ii) the member established a track record of adequate macroeconomic policies over a period of at least six months immediately prior to the request. Such track record could be established, inter alia, under an SMP and the repeated RFI financing could in this way support the transition toward a UCT-quality program, provided that relevant criteria are met. Under the current RFI framework, purchases are not subject to a per disbursement access limit and the limit of no more than 2 disbursements in a 12-month period does not apply. Thus, staff does not propose modifications to the RFI framework which already allows concurrent use of the RFI with SMPs.

²⁵ This proposal would also be available for non-FCS.

33. **Staff also proposes increasing the cumulative access limit (CAL) under the RCF regular window to 150 percent of quota—equal to the current CAL under the RCF exogenous shock window—until end June 2023.** The access limits of the exogenous shock and LND windows of the RCF and the regular and LND windows of the RFI were temporarily increased in the context of the COVID-19 pandemic. While the annual access limits (AALs) under these windows reverted to the pre-pandemic levels at end-2021, the current level of the CALs was extended for 18 months until June 2023.²⁶ The extension aims to avoid a situation where a large number of countries that received emergency financing assistance during the COVID-19 pandemic would face severe constraint to access the RCF/RFI for several years, if the CALs were to revert to the pre-pandemic levels.²⁷ However, if the CAL of the RCF regular window is kept at the current level (100 percent of quota), many countries will continue facing severe constraints in accessing the RCF regular window, which is the window that allows repeated use when linked to a track record of adequate macroeconomic policies (Figure 1).

Figure 1. Distribution of Outstanding RCF Credit in LIC FCS (Number of countries, as of November 2, 2021)



Sources: Staff calculation

34. **The 150 percent of quota cumulative access limit would provide additional flexibility for Fund support to FCS with the possibility of low-access RCF support for building a track record.** The relatively low annual access limit will mitigate the risk of facility shopping and provide a financial incentive for member countries to move toward a UCT-quality program. Staff will review the CAL for the RCF regular window as part of an exit strategy towards a post-pandemic emergency financing access limit policy, which is to be presented to the Board by June 2023.

SHORT-TERM UCT-QUALITY ENGAGEMENT FOR PRGT-ELIGIBLE FCS WITH PROTRACTED BOP NEEDS

35. **Lending facilities under the PRGT are differentiated primarily by the duration of the financing, the adjustment needs, the nature of the economic program and related conditionality standard.**²⁸ The 2009/10 reform of the LIC facilities' architecture ensured that the

²⁶ [Review of Temporary Modification of the Fund's Access Limits in Response to the COVID-19 Pandemic](#).

²⁷ Specifically, as a result of extensive use of the RCF during the pandemic, the outstanding RCF exposure reached 100 percent of quota or more in 11 countries out of 42 LIC FCS, while it exceeded 50 percent of quota in 13 LIC FCS. PRGT-eligible countries among those on the IMF FY19 FCS list or WB FY21/FY22 FCS lists.

²⁸ [A New Architecture for Low-Income Countries](#), paragraph 6.

two UCT-quality facilities (the SCF and ECF) did not overlap— they are delineated by the length of the financing and adjustment needs to address the respective BoP problems faced by the member, which is judged to be either “short term” or “protracted”.²⁹ The reform also preserved the longstanding presumption that protracted BoP problems are best addressed via a three-year or longer arrangement, in part because it grounds policy advice within a medium-term policy framework and the countries’ poverty reduction and growth objectives.

- The SCF, which allows for shorter duration UCT-quality support, requires that the BoP needs, be short-term in nature and has not generally been employed in FCS in light of the long-term (rather than episodic) nature of their problems.³⁰
- The purpose of the ECF is to support programs that enable members with protracted BoP problems to make *significant progress towards* a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth. Programs under the SCF and the ECF must meet the UCT-quality conditionality standard.
- For countries with protracted BoP problems that lack the capacity to implement a UCT-quality program, RCF support can help meet urgent financing needs while assisting the country to *move toward* a stable and sustainable macroeconomic position, including potentially through a track record for an eventual ECF arrangement.

36. **The 2018 IEO report on “The IMF and Fragile States” identified a potential gap between lending instruments designed for rapid support, with limited conditions, and those for more sustained support, with much higher policy standards.** It reported suggestions from stakeholders to find “ways to increase access under the existing PRGT facilities, for example by raising annual access limits under the RCF, or by allowing for a short UCT arrangement as a bridge to a possible ECF arrangement.

37. **The 2018/19 Review of LIC Facilities therefore analyzed the option of introducing a shorter-term UCT-quality arrangement for countries that do not qualify for an SCF arrangement.** Such arrangements might be appropriate to the extent that there are

²⁹ As discussed in the 2009 Board papers on the architecture of LIC facilities “the delineation of the ECF and SCF on the basis of the duration of the financing and adjustment need implies that other factors typically associated with protracted or short-term needs are not used as defining criteria. For instance, while structural maladjustments would almost always be expected to underlie a protracted need, they do not *per se* define the protracted balance of payments problem standard, which helps avoid gaps in the new architecture” (SM/09/160, Footnote 9). Also, under the architecture a protracted BOP problem exists when the resolution of the underlying macroeconomic imbalances would normally be expected to last three years or more, and in any case, more than two years, ([A New Architecture for Low-Income Countries](#), SM/09/160, footnote 7).

³⁰ Specifically, the purpose of the SCF is to support programs under the SCF that enable members with actual or potential short-term BOP needs to achieve, maintain, or restore stable and sustainable macroeconomic positions consistent with strong and durable poverty reduction and growth. In approving an SCF, the Fund must be satisfied, *inter alia*, that the member does not have a protracted BOP problem, and has an actual or potential short-term BOP need that is expected to be resolved (or in the case of a potential BOP need, would be expected to be resolved) within two years and in any event no later than three-years.

circumstances where the highest priorities are short term in nature and policy discussions on medium-term objectives and policies may be a distraction, e.g., in post-conflict or near-conflict situations where an appropriately designed short-term arrangement can deliver very large payoffs or in situations of uncontrolled inflation, where a tightly focused stabilization program that succeeds would represent an essential step forward towards a sustainable position. However, the proposal received mixed views at the time. While many Executive Directors were open to exploring a sufficiently ring-fenced shorter-term instrument, many others underscored that longer program periods are needed for LICs to make significant progress towards a stable and sustainable position.

38. Introducing a short-term UCT-quality facility for protracted BoP problems entails significant challenges, and the 2018/19 Review instead focused on making full use of the inherent flexibility allowed under the ECF. Specifically, Executive Directors endorsed greater flexibility in the design of ECF-supported programs for countries that need to focus on near-term objectives, while meeting UCT-quality standards and maintaining consistency with the provisions of the ECF. When analyzing the option of a “short-term ECF”, staff identified a range of substantive policy, legal, and safeguards challenges:

- Introducing a short-term ECF *for general use* would be a significant departure from the logic of the PRGT facilities architecture. As noted above, the SCF and ECF were delineated by the length of the BoP problem addressed. A short-term ECF would make this distinction much more difficult, with the risk that countries with short-term needs might request short-term ECF support for longer repayment terms.
- A short-term ECF might encourage countries with protracted BoP problems to seek shorter-term financing in “bad times” while eschewing a medium-term program and Fund engagement during cyclical upswings (“good times”) when policy buffers need to be re-built and deeper reforms should be undertaken. A minimum of 3-year commitment to work with the Fund under a UCT-quality arrangement is an important safeguard that mitigates this risk.
- While medium-term policies and reforms cannot always be fully fleshed out at the outset, three-year ECF arrangements can accommodate economic and policy uncertainty including in situations of fragility and political instability. For instance, the ECF has considerable flexibility in defining specific policies and reforms for the outer years in program reviews.³¹ Moreover, for transitions toward a multiyear ECF arrangement, the Fund can provide support under the RCF if there are urgent BoP needs and all other applicable policy requirements are met.

³¹ The 2018-19 Review of Facilities for Low-Income Countries-Reform Proposals (SM/19/100) , pages 22-26, which lay out a range of options for more flexible use, including using the ECF to support a program with streamlined conditionality that focuses on near-term stabilization needs, guided by broad medium-term objectives, while fleshing out further program specifics as the ECF arrangement unfolds.

- On the legal front, the shortening of the duration of the ECF arrangement also raises questions of consistency with the current purpose of the ECF, a protected provision, which is to enable countries with a protracted BoP problem make *significant progress towards* a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth.

39. **More recently, in the context of Fund-wide work to develop a new strategy for engagement with FCS, staff has revisited the case for allowing flexibility on the minimum duration of ECF arrangements to enable the Fund to be appropriately agile in supporting such members.** Key themes of work on the FCS Strategy include the heterogeneity of the pool of FCS, and the need to place each Fund arrangement with a particular FCS into a potential succession of engagements guided by a long-term strategy—10, 15, 20 years or longer for some countries. Over this timeline, it is likely that the Fund will need to engage with FCS through a range of instruments, not limited to 3–5-year ECF arrangements, depending on the circumstances at the time. Thus, for FCS that are engaging effectively with the Fund in a sustained manner, a coherent long-term engagement strategy (via the CES) seems at least as relevant as the duration of a specific Fund-supported program. For PRGT-eligible FCS with protracted BOP needs, staff is of the firm view that the current 3-5 year ECF arrangement should remain the workhorse instrument. At the same time, the option of a short-term UCT arrangement for FCS facing protracted BoP problems, as a transition to a 3-5 year ECF arrangement, could enhance the agility of the concessional lending toolkit, which may help better tailor Fund financial support to FCS.³²

40. **The October 2021 discussion paper therefore proposed reopening the issue of shorter-term UCT support in carefully delineated circumstances and taking into account the challenges identified in the 2018/19 review.** The paper suggested that the gap is particularly relevant for PRGT-eligible FCS with protracted BOP problems (which precludes the use of the SCF) that need to implement significant stabilization measures but are not in a position to implement a three-year program (ruling out the use of the ECF as currently designed). Even though exceptional, such situations may occur, typically in post-conflict, post-disaster, or other crisis situations, where policy capacity is constrained, and there is a need for stabilization measures. In these circumstances, support could also be provided through a combined use of RCF/SMP, but access may be too low or the duration too short, and donors may seek a stronger signal through a UCT quality engagement.

41. **Staff have therefore considered three options to enhance flexibility and address potential gaps in such circumstances, for the consideration of Executive Directors:**

Option 1: Using the existing flexibility in ECF arrangements

42. **A first option to enhance short-term UCT-quality engagement with FCS would be to use more actively the existing flexibility under the ECF as proposed in 2019.** The ECF framework

³² Enhancing Fund Financial Engagement in Fragile and Conflict-Affected States—Options for Discussion (FO/DIS/21/134)

offers significant flexibility in defining specific policies and reform agenda for the outer years in subsequent program reviews, making it possible to focus the first year conditionality on near-term stabilization needs, guided by broad medium-term objectives, while fleshing out further program specifics as the ECF arrangement unfolds. Three-year ECF arrangements can thus accommodate economic and policy uncertainty including in situations of fragility and political instability, by progressively developing a medium-term policy agenda through program reviews while focusing short-term stabilization at the outset of the program.³³

43. **It remains to be seen whether such flexibility, together with concurrent SMP and rapid financing, is sufficient or not to meet the needs of FCS members in all circumstances.** As this approach was only set out shortly before the pandemic, there has been limited experience in exercising full flexibility under the current architecture. Staff have identified a number of recent cases where a shorter-term UCT arrangement might have been more appropriate, such as some countries with a transitional government. Moreover, there may be some situations where even broad medium-term objectives and policy commitments cannot be secured at the outset, e.g., due to political or legal constraints, such as post-conflict transitional government with time-bound mandate. Even though exceptional, these cases might not necessarily be covered by the existing flexibility under the ECF.

44. **Option 1 would therefore consist of providing clear guidance on the use of existing flexibility, and careful monitoring to assess whether any gaps remain, to prepare for the next comprehensive review of LIC facilities.** As noted above (¶112), staff plans to develop a new guidance note of engagement with FCS including advice to help ensure that programs for all FCS are well tailored to country circumstances, and that conditionality closely follows the principles of parsimony and criticality. If further experience demonstrates that such flexibility, together with the option to use an SMP with concurrent rapid financing, is not sufficient to meet the needs of FCS members effectively, this gap would be addressed in the context of the comprehensive review of LIC facilities planned for 2024/25.

Option 2: Lowering the minimum duration of the ECF in a tightly ringfenced manner

45. **A second option explored by staff was to introduce some flexibility in the minimum length of ECF arrangements that would be available only in exceptional circumstances.** Under this option, a shorter arrangement duration would be permitted in certain exceptional and tightly ringfenced situations, with the length of the arrangement ranging as low as 18 months.³⁴ Exceptional situation would include, for example, where countries embark on significant flagship reforms but where a 3-year or longer ECF is assessed to be infeasible--such as when an interim government has a limited legal mandate--with the staff report for the request for a shorter-ECF arrangement clearly explaining why a 3-year ECF arrangement is infeasible. The broad contours of quantitative and

³³ See 2018-19 Review of Facilities for Low-Income Countries-Reform Proposals (SM/19/100), pages 22-26.

³⁴ Staff did not explore the potential for ringfenced arrangements with durations below 18 months, as such situations would better be handled with SMP/RCF combinations.

structural conditionality, access levels and financing terms would be identical to those for 3–5-year ECF arrangements, and standard poverty reduction requirements would apply. Only the duration would differ from the regular 3–5 year ECF arrangement, on an exceptional and ringfenced basis. However, the lack of medium-term commitments would require additional safeguards.

46. **However, after further analysis, staff is of the view that there are no legally feasible ways to ringfence eligibility for a shorter duration ECF arrangement for the member-specific circumstances envisaged, and therefore this specific option is not examined further.** As a general matter, the principle of uniformity of treatment applies to all use of the Fund's resources under the Articles of Agreement (including the use of SDA resources in the PRGT). Under this principle, any decision by the Fund to differentiate between members must be based on the application of criteria that are relevant to the objective of the power being exercised.³⁵ With respect to the PRGT, the Fund has generally limited developing countries' eligibility and qualification to receive Fund resources on the basis of the application of two criteria: (i) level of per capita income and (ii) nature of balance of payments problem.³⁶ The envisaged "exceptional circumstance" that would allow access to the shorter ECF arrangement (e.g., interim government, see ¶43 above) has no direct bearing on the type and nature of the underlying BoP problem (i.e., protracted BoP problem). There is no legally feasible way consistent with uniformity of treatment considerations to justify shorter ECF arrangements for members that otherwise need closer monitoring (because they have greater institutional limitations such as interim governments or limited mandates) while excluding members with greater economic stability and stronger institutional capacity from accessing such arrangements. As such, if a shorter ECF arrangement is considered appropriate for addressing members' protracted BoP problems, then all members facing such protracted BoP problems should be allowed to access a shorter ECF arrangement.

Option 3: Creating a new window under the ECF

47. **A third option to enhance the agility of the lending toolkit would be to introduce a new window under the ECF enabling shorter-duration arrangements for countries facing protracted BoP problems with lower access and less adjustment, that would act as a bridge to a regular ECF.** This would help the Fund better serve the heterogenous needs of FCS (see ¶39). Such short-term UCT-quality arrangements would particularly benefit FCS where the authorities have

³⁵ For example, when exercising its authority under Article V, Section 3(a) to make its general resources available to help resolve balance of payments problems, the Fund is authorized to differentiate the terms of financing provided (e.g., the length of the repurchase period and/or the rate of charge) on the basis of the nature of the balance of payments problem being financed. This has been achieved through the establishment of special facilities, whereby the eligibility to receive preferential terms has been limited to those members that are experiencing the specific type of balance of payments problem being financed (e.g., Extended Fund Facility). With respect to the PRGT, Article V, Section 12(f)(ii) sets forth an important—but limited—exception to this general rule. Specifically, it authorizes the Fund to use SDA resources, inter alia, to provide balance of payments assistance on special terms only to developing countries; i.e., developed countries may be excluded from eligibility under this sub-clause even if they are experiencing the type of balance of payments problem being financed. *However, among developing countries, the principle of uniformity of treatment applies.* (see The G-8 Debt Cancellation Proposal and Its Implications for the Fund, SM/05/284).

³⁶ The G-8 Debt Cancellation Proposal and Its Implications for the Fund, SM/05/284.

well-developed ideas of reforms that can be implemented quickly, and would benefit from the structure and catalytic effect of a UCT-quality arrangement before transitioning when feasible to a regular medium-term ECF. As a legal matter, to ensure uniformity of treatment—and therefore avoid the specific problems of option 2 above (¶46)—the new window would be available to all PRGT-eligible members facing protracted BOP problems, although it would be designed in a way that seeks to limit its use (¶49-50).

48. **Under such a new ECF window, countries would be expected to make good progress towards a sustainable position, supported by UCT-quality conditionality (quantitative and structural) similar to those for the typical 3-5-year ECF-supported programs.**³⁷ Programs would likely build on previous TA and engagement and be part of the longer term CES and pay-offs should be rapid and large if program design is well calibrated. Examples of potential reforms for which good progress can be made include policy actions that would contribute to regaining economic and social stability—restoring fiscal discipline through budgetary and spending control reforms, unifying the exchange rate, reducing very high inflation, and ensuring orderly international payments (including on accumulated liabilities)—thus making progress at least on addressing flow imbalances. There would also be circumstances where a few more ambitious macro-critical structural reforms can be launched and bear fruits in the near term (e.g., strengthening central bank autonomy and governance, improving SOE oversight, introducing a Treasury Single Account, and improving debt reporting).

49. **Although further analysis would be required on the design of a new window under the ECF, its main features on a preliminary basis could be as follows:**³⁸

- **Duration:** 18-to less than 36 months. The duration would allow for engagement for significantly shorter periods than the current ECF, but no less than 18 months.
- **Program objectives:** In view of the shorter program duration relative to a “regular” ECF arrangement, the member would only be required to make “good progress” (instead of “significant progress”) towards a stable and sustainable macroeconomic position, i.e., such progress would likely be more limited during programs supported under this window than the 3-5 year programs supported under the regular ECF arrangement³⁹, while still ensuring that the

³⁷ The new instrument could include features to ensure that progress towards addressing medium-term goals is met, such as (i) requiring that the authorities adopt a Poverty Reduction Strategy prior to the second review; and (ii) completing a minimum of three reviews.

³⁸ Should Directors support this option, these considerations and strategic objectives could be reflected in the final Board paper and associated Board summing up.

³⁹ The purpose of an ECF arrangement is to assist PRGT-eligible member countries with a protracted balance of payments problem in implementing economic programs aimed at making significant progress toward a **stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth**. Such a position would be characterized by the absence of a present or prospective balance of payments need and by the domestic and external stability that is necessary to support strong and durable poverty reduction and growth. It would typically be associated with sustainable fiscal and current account balances, limited debt vulnerabilities,

(continued)

strength of policies are such that program meets of UCT-quality standards⁴⁰. A program would be assessed to allow “good progress” when, at a minimum, it would be expected to stabilize the macroeconomic position and deliver progress in terms of all the *macroeconomic flow balances* associated with a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth- i.e., achieving sustainable fiscal and current account balances and adequate international reserves. Progress on addressing debt vulnerabilities along with improvements in policy and institutional capacity would also be expected, albeit on a more limited scale than under a 3-5 year ECF arrangement.

- Access/Lending terms: As a safeguard in light of the shorter program commitment, hard caps on access would be set at a low level, which is also expected to help deter opportunistic behavior (see ¶150). For example, a hard cap of 75 percent of quota for 18 months (and equivalent to 50 percent per annum for longer periods) would be in line with the 3-year ECF norm and the RCF norm (normalized to the same duration, assuming repeated use of RCF). Lending terms would be the same as for regular 3–5-year ECF programs.
- Conditionality: Conditionality would meet the UCT standard. The policies applying to quantitative and structural conditionality would be identical to those for regular ECF arrangements, and standard poverty reduction requirements would also apply. However, the shorter duration may limit the scope and depth of entirely new structural reforms or constrain the implementation of the necessary measures that help underpin the “significant progress towards a stable and sustainable macroeconomic position” that is part of the current ECF legal framework.
- Sunset and review clauses: A “sunset clause” could be introduced, to monitor the adequacy and relevance of the window during a period of 5 years, after which the new window would automatically expire if there has been no demand. Furthermore, if there is demand, the experience could be assessed in the context of the next LIC Facilities Review, expected in 2024/25.
- Repeated use: To discourage opportunistic use of this window (see below), a strict limit on repeated use would be included in the qualification criteria.⁴¹
- Consent requirements and voting majorities: Introducing this window in the ECF would amount to a change in the purposes of the current ECF. Specifically, it would require the purpose of the

adequate international reserves, and sufficient policy and institutional capacity to implement appropriate macroeconomic policies.

⁴⁰ “Good progress” would be a higher standard than what is expected under the RCF which has as a purpose “to support policies [as opposed to programs] of members facing urgent balance of payments needs so as to enable them to make *progress* towards achieving or restoring stable and sustainable macroeconomic positions consistent with strong and durable poverty reduction and growth” (PRGT Instrument, paragraph 1 (a) (iii))

⁴¹ If introduced, staff envisages that members would be allowed to use such a window no earlier than three years after the initially agreed expiry of its previous such arrangement. For example, if a two-year arrangement were agreed, a subsequent request could be considered only at the five-year mark.

ECF to be broadened to replace “significant progress” toward a stable and sustainable macroeconomic positions consistent with strong and durable poverty reduction and growth, with “good or significant progress”. This change in the purpose of the ECF for the short-term window amounts to a fundamental change to the facility as “good progress” in the case of the short-term window requires a materially lower level of adjustment than “significant progress” under the standard ECF arrangements. Any change to the purpose of the PRGT facilities can only be made with the consent of loan and subsidy account contributors (“protected provision”).⁴² It would further require approval by the Board with an 85 percent majority of the total voting power as the modification would change the authorized use of SDA resources in the PRGT.⁴³

50. If such a window were introduced, it should be designed in such a way to seek to mitigate the risks identified in the context of the 2018/19 LIC Facilities review:

- Opportunistic behavior: the appropriate instrument for addressing protracted BoP problems would normally be a medium-term program. In contrast, shorter-term engagement could potentially allow countries to engage with the Fund during crises but avoid making the necessary reforms and building buffers during better times.⁴⁴ The lower required adjustment under this instrument could exacerbate this phenomenon, although it would be mitigated by the proposed restriction on repeated use as well as the lower level of access. If members request access under the window, staff would need to assess carefully on a case-by-case basis whether the authorities’ program is of UCT quality, debt sustainability requirements are met and capacity to repay is adequate. The Fund would reject requests for an arrangement under the window if these and other applicable policy requirements are not met.
- Lower demand for regular ECF support: the 3-5 year ECF arrangement has been a successful workhorse of Fund engagement with LICs over decades. The new instrument could reduce demand for more sustained engagement and overall reduce the Fund’s effectiveness in addressing protracted BoP problems. In addition to the deterring effect of lower access level, the Executive Board could provide strategic guidance to emphasize that protracted BoP problems are normally best addressed via a three-year or longer ECF arrangement, to require staff to provide a clear explanation of why a member meets all the requirements under the window, alongside an explanation as to why the member is not in a position to implement a medium-

⁴² Pursuant to Section IX of the PRGT Instrument, certain provisions of the PRGT Instrument are protected provisions, in the sense that they cannot be amended by the Executive Board alone. Changes to protected provisions can only be effective with the consent of the affected contributors to the trust. The provisions of Article I, Paragraph 1 of the PRGT Instrument on the purposes of the various PRGT facilities is a protected provision.

⁴³ Article V, Section 12(f)(ii) of the Articles of Agreement specifies that decisions regarding the use of SDA resources for special balance of payments assistance for developing members shall be taken by an 85 percent majority of the total voting power. As the PRGT includes SDA resources, any decision to change the purpose for which those resources may be used constitutes a new use of SDA resources and requires, in addition to the contributor consents, an 85 percent majority of the total voting power.

⁴⁴ The 2018 LIC report “Macroeconomic Developments and Prospects in Low-Income Developing Countries—2018,” found that, for PRGT-eligible countries that had Fund arrangements, debt accumulation was lower during program periods than outside program periods.

term program, and to encourage members to use the window only as a bridge to a regular ECF arrangement.⁴⁵ Scrutiny of the consistency with this strategic guidance would be especially strong in cases of repeated use.

- **Safeguards concerns:** the medium-term nature of the current ECF arrangements is a critical safeguard to ensure that members are committed to working with the Fund on appropriate policies over the economic and political cycle. Implications of the post-program financing gap for capacity to repay the Fund and debt sustainability would need to be carefully assessed and potential additional safeguards (e.g. on debt or reserves) could be required, bearing in mind the higher risks associated with a short-term instrument. Constraining access levels with a relatively low hard cap would reduce the Fund's exposure along with the attractiveness of the window vis-à-vis the ECF. However, access may still be sizable for countries with high quota-to-GDP ratios, and therefore staff would need to carefully assess capacity to repay in such cases.

51. **The creation of such a window would represent a fundamental change in the PRGT architecture.** As detailed in ¶35-38, creating a new short-term window in the ECF would be a departure from relying on the duration of the financing and adjustment as a key conceptual underpinning of the current architecture. While the new window would differ from the SCF in terms of the duration of the BoP problems they are designed to address, there is a risk that countries with short-term needs would request a shorter-term ECF arrangement rather than the SCF in view of the more favorable financing terms. It could also present a potential overlap with the RCF which, under the current architecture, can be used repeatedly⁴⁶. In this context, it will be essential to consider the overall architecture of the LIC facilities when developing a new window in order to ensure coherence and the avoidance of gaps and overlaps, including to support the strong consensus needed for its adoption as outlined in ¶49.

ISSUES FOR DISCUSSION

- Do Directors support the proposals made to strengthen program design through realistic macro framework and tailored conditionality?
- What are Directors' views on how Fund engagement and partnerships could be leveraged more to help FCS raise grants?
- Do Directors support the greater use, where appropriate, of concurrent SMPs and repeat emergency financing to help smooth the transition to a UCT-quality program? What are Directors' views on the proposed targeted adjustments to the RCF framework?

⁴⁵ In a similar vein, as noted in the 2016 Board paper, while all Fund members have access to GRA resources, the Board has encouraged staff to advise PRGT-eligible members to seek support from the PRGT rather than GRA.

⁴⁶ See figure 1 in SM/09/160.

D. What are Directors' views on short-term UCT-quality engagement for PRGT-eligible FCS facing protracted BOP needs and the potential development of a new window within the ECF?