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Rebuilding the Global Economy

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MEMORANDUM ON

STRENGTHENING THE ROLE OF THE INTERNATIONAL MONETARY FUND TO ENHANCE GLOBAL RESILIENCE TO CRISES

To: The Managing Director of the International Monetary Fund
From: José De Gregorio
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Background: The world rightly expected a series of crises to afflict the emerging-market and developing economies (EMDEs) as a result of the COVID-19 pandemic. This concern seemed inevitable, given the massive capital outflows at the beginning of the crisis. But that has not happened. Since the start of the COVID-19 crisis, the International Monetary Fund (IMF) has swiftly adjusted its financing facilities to face the emergency. The Fund has about $1 trillion for financial support, of which a quarter has been made available, and it is ready to do more. It has acted properly and in a timely manner given the magnitude of the crisis.

The IMF's policies, along with the macro stimulus undertaken by the advanced economies as well as many EMDEs, and central bank actions successfully prevented crises.[1] Their actions do not remove concerns about financial fragility or the human and economic toll of the pandemic. But the IMF's mission and new emphasis on rapid response with less rigid baggage has been vindicated.

The Fund increased access to its facilities that provide fast financial assistance, such as the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI). Access to the RCF and RFI, without ex post conditionality, has been increased from 50 to 100 percent of an IMF member's quota per year and from 100 to 150 percent on a cumulative basis. Overall limits have also been increased, from 145 to 245 percent of quota per year under the General Resources Account (GRA) and the exceptional access limit under the Poverty Reduction and Growth Trust (PRGT) from 50 percent of quota to 183.33 percent. All of these limits have been increased until April 2021. The Fund also created a new credit facility, the Short-Term Liquidity Line (SLL).

1 At the end of 2019, the index for credit default swaps (CDS) for EMDEs closed at 174 basis points, at the peak of the turmoil in mid-March 2020 it jumped to 465 basis points, and then has declined to 165 basis points recently. Many EMDEs have tapped international financial markets.

A total of 83 countries have received financial support from the Fund since late March 2020 , for a total of $102 billion.[2] Most countries (71) have received assistance from the RCF, RFI, or both, with an approved amount of $30 billion. In contrast, only 3 countries have received approval for about half of resources committed, $52 billion, through the FCL: Chile, Colombia, and Peru.[3] A total of 29 countries, most of which have also received some other emergency financial assistance, have been granted debt service relief from the Catastrophe Containment and Relief Trust for $250 million in April and for $237 million in October. Finally, the Fund has extended two Stand-By Arrangements for $10 billion and two Extended Fund Facilities and made several augmentations to existing programs.

KEY PRIORITIES

PRIORITY 1: Facilitate fiscal expansions with backloaded consolidation

Public finances are under stress, and weaknesses are likely to continue at least through the next year. IMF projections in October indicate the world budget deficit will increase from 3.9 percent of global GDP in 2019 to 12.7 percent of GDP in 2020. The fiscal deficit of EMDEs is forecast to increase from 4.9 percent of EMDE GDP in 2019 to 10.7 percent in 2020. The expected reversion will be gradual, as economies are expected to experience only a partial recovery. Fiscal support will be needed at least for the next couple of years.

In order to avoid undesirable early fiscal consolidation, fiscal adjustments must be backloaded and the Fund must be prepared to increase lending. In this regard, it would be convenient for the Fund to increase access on a cumulative basis to access before its 14th General Review of Quotas of 2016, which was 600 percent of quota, well above the current 435 percent. In addition, for small and low-income countries, access to RFI and RCF could be doubled to 200 percent of quota in a year and 300 percent on a cumulative basis.

There is wide heterogeneity of financial assistance across countries. Moreover, it is remarkable that only a small number of countries has been approved for an FCL, the IMF's largest and more flexible credit facility. This could be because few EMDEs have "strong public fundamentals and institutional policy framework" or because many eligible countries have chosen not to apply for the FCL. Indeed, no country from the Association of Southeast Asian Nations (ASEAN) and major country of emerging Europe has applied for the FCL. However, it cannot be ruled out that some countries may not be interested in applying because of stigma, and for this reason a confidential prequalification process could be implemented for the FCL and SLL or a fast preliminary assessment could be provided. Moreover, as the health crisis prolongs in some EMDEs, the Fund could create a new Pandemic Support Facility, which should provide fiscal and balance of payment support specifically to deal with the health crisis for a period of three years.

Although the Fund has made available a quarter of its firepower to EMDEs, only a tenth has been granted in the first eight months of the COVID-19 crisis. Indeed, this amount is less than what was committed in the first eight months of the global financial crisis. The current availability of private financing and the fact that many countries entered the crisis

2 An exchange rate of 1.38 dollars per special drawing right (SDR) has been used to express amounts in US dollars. For details on the IMF response, see here.

3 With respect to the quota, Chile was approved for 10 times its quota. Mexico, not included in the figures above because it was approved in 2019, has the largest amount committed, $61 billion, five times its quota. No country has made use of the funds from this facility, which provides unlimited access.

with buffers, such as sovereign wealth funds and international reserves, may explain the low demand for borrowing during the current crisis. However, it cannot be ruled out that issues such as stigma and access constraints are preventing some economies from seeking financing. For this reason, the Fund should revise access and qualification mechanisms, as discussed above.

Member economies borrowing from the Fund should have credible medium-term fiscal consolidation programs. The IMF has a dual role with respect to members. First is to provide financial assistance, which it has done efficiently, but more may be needed. However, in terms of fiscal expansions to foster a recovery, emphasis should be on digitalization, fighting climate change, and helping reduce the large increase in poverty that the crisis has generated. Second, the Fund, in the context of surveillance, monitors fiscal developments in borrower countries. EMDEs need to avoid fiscal inertia, but consolidation must wait until economies return to some normality.

This is an opportunity to strengthen the role of the Fund not only in the current crisis but also in the longer term. The increased access to some IMF facilities should be made permanent and not ended in April 2021.

PRIORITY 2: Take three steps to increase global resilience to crises

Increase availability of resources

In terms of resources, it seems the $1 trillion may be enough firepower under current circumstances. However, a deterioration of financial conditions in EMDEs may require additional resources. Moreover, the crisis will be long, and therefore the Fund should increase its firepower. A new $1 trillion issue of the Fund's special drawing rights (SDRs) would be desirable.[4] While SDRs are allocated to member countries according to quotas, a nonproportional allocation could be achieved by creating a common pool overseen by the Fund, to expedite financial support to countries in need. Resources from the IMF provide not only liquidity but also insurance against future constraints on foreign financing.

Provide more debt relief

The IMF also has a global role in the international financial system. The Common Framework for Debt Treatments Beyond the Debt Service Suspension Initiative (DSSI) endorsed by the G20 and the Paris Club is a step forward, however insufficient. The DSSI was designed as debt service postponement for 73 low and lower-middle income countries. In contrast, the Common Framework is debt relief, on a case-by-case basis, which is essential for countries that have become insolvent. Another important advantage of the Common Framework, compared with DSSI, is that it includes the private sector, which implies that the question of whether an autonomous public financial institution should enter DSSI is no longer an issue in the Common Framework and should participate.

The Common Framework should be extended to emerging markets deemed to be insolvent. There are issues of moral hazard in countries that have been fiscally irresponsible. For this reason, an extension to emerging market economies should be for those that have reached insolvency only as a result of the COVID-19 crisis. It is also important to increase private

4 A number of policymakers and academics have proposed such an allocation of SDRs, as well as the idea of creating a common pool.

sector involvement to have equitable burden sharing. The IMF should work within the G20 on new initiatives for sovereign debt restructuring. In the meantime, it should also incentivize the use of financial instruments that make public financing of EMDEs more resilient, such as bonds indexed to commodity prices or to GDP or more in general state contingent bonds.

Develop the Integrated Policy Framework

In terms of policy advice the Fund has changed. For example, its views on the benefits of procyclical fiscal policy, exchange rate intervention, and capital controls have been gradually changing, since the aftermath of the Asian financial crisis, to a more realistic approach, recognizing that one size does not fit all.

The Fund has been recently developing an Integrated Policy Framework, which focuses on the optimal combination of policy tools to face volatile capital flows. For this reason, monetary policy and exchange rate flexibility could be complemented with macroprudential measures, capital flows measures, and foreign exchange intervention. This is a valuable exercise, founded in rigorous economic analysis and review of experiences. However, it should not be used to support inconsistent policies or to ignore fiscal sustainability. For example, foreign exchange intervention and capital controls cannot be used for sustaining exchange rate misalignment. It is also necessary to be clear about what is the target for different combination of policies and their implications on external adjustment. Are capital controls aimed at exchange rate competitiveness or capital flows volatility and financial stability? What would happen if all EMDEs tried to stabilize the currency when facing a global depreciation of the dollar? Having a flexible approach to macroeconomic policies is important, however it should start with recognizing the role of fundamentals and the difficulty to reach clear cut general recommendations. In any case, it is a step toward the old view that all problems are fiscal and therefore the solution requires fiscal tightening. This is particularly relevant during global crises.

Uncertainty in the global economy is daunting, particularly given the uncertainty on the health front. So the Fund has to be prepared for these contingencies, act with the speed and flexibility it has already shown in the first year of the crisis, and add building blocks to a safer and more resilient global financial system.