Follow-up on the High-Level Event on Financing for Development in the Era of COVID-19 and Beyond

Discussion Group III: Global Liquidity and Financial Stability

Background Document

Background

Global liquidity shortages and capital flow volatility

After intense market volatility, and a record capital outflow from developing countries of around $100 billion between late January and the end of March 2020, international financial markets have recovered somewhat. During April and May, emerging markets attracted around $23 billion in capital inflows. Although several developing countries were able to issue new debt (e.g. Guatemala, Paraguay, Egypt, Albania and Brazil), many developing countries – especially the poorest and most vulnerable – do not have this option. A number of countries, including SIDS and middle-income countries, have also eased restrictions on capital account inflows and managed outward foreign currency payments to respond to the heightened capital flow volatility caused by the economic crisis associated with COVID-19.

Liquidity pressures associated with COVID-19 and its economic fallout have hindered the ability of many developing countries to service their debt. On 15 April 2020, the G20 committed to allow IDA-eligible and least developed countries to suspend debt service payments owed to G20 country official creditors. While the initiative will free resources of participating countries in the short term, the suspension extends only to official bilateral debt, which represents around one third of external debt service of eligible countries through the end of 2020, and also does not include liquidity constrained middle income countries.

As noted in the Discussion Note, many countries continue to experience severe liquidity shortages. The absence of timely support could magnify the scale of the financing challenges and potentially trigger a wave of debt and financial crises.

Menu of policy options

- **IMF issuance of Special Drawing Rights (SDRs)**

There are currently a range of proposals to use SDRs to support countries in need, which would require different levels of political agreement:

- *Reallocation of existing SDRs* -- IMF member countries could reallocate existing SDRs from countries with sufficient international reserves to those countries most in need. There are several options for this. For example, countries that don't use their SDR allocations could place them in a trust fund at the IMF, which would make SDRs available to countries upon request. Such a trust could be modelled on the IMF's Poverty Reduction and Growth Trust or the Catastrophe Containment and Relief Trust, but not limited to low-income countries. However, even a reallocation of $150 billion from high-income to low and middle-income countries would likely be insufficient for countries in need.
- *New issuance of SDRs* -- A new issuance of SDRs would require 85 per cent of the voting power of the IMF membership. However, without a reallocation the funds would not necessarily reach countries most in need as high-income countries would receive almost two thirds of any new allocation, in line with their IMF quotas. Even so, an issuance of $1 trillion would provide low and middle-income countries with around $330 billion of additional international reserves. A smaller issuance of $600 billion may be more feasible, as it would not require parliamentary approval by some large member countries.

- *New issuance with reallocation of SDRs* -- A third option would be the issuance of new SDRs, together with a mechanism for their subsequent reallocation to countries most in need. If such a mechanism or trust fund were to be developed as part of a first step to reallocate existing SDRs, it would be ready for use under this scenario. The combination of a new issuance with a reallocation would enhance the liquidity impact of the issuance without (much) additional cost for those countries who do not use their allocations. Alternatively, wealthier countries could lend their unused SDRs back to the IMF to increase its lending capacity.
- *Use SDRs to finance SDG or COVID-19 response related funds* -- Other proposals include the use of SDRs for asset purchasing programs or debt buyback funds, to support COVID-related expenses, or for climate investments. Trusts like the PRGT could be set up at the World Bank and the regional development banks (which are already prescribed holders of SDRs).
- *More expansive uses of SDRs* -- More frequent SDR allocations in the future could further support global liquidity. A more ambitious role for SDRs would also be to increase their use as a global currency or an investment asset by actors beyond central banks– this may also require institutional changes, and may lack sufficient political support.

- **Asset purchasing programme to support market access**

The international community could support countries with sustainable debt to maintain access to financial markets, e.g. through a global asset purchasing programme. The African Union has suggested creating a Special Purpose Vehicle to subsidize private sector investment in African sovereign dollar debt. Such programmes would lower borrowing costs for sovereigns, and could help maintain/ create market access for some countries. The necessary funding could be supported by Special Drawing Rights issuance or partial public guarantees. As this could add to the debt burden of countries, it would not be a solution for highly indebted countries. In addition, the structure of the programme would need to be designed to avoid bailing out private creditors and ensure appropriate burden sharing.

- **Improve capital account management tools**

Develop frameworks for capital account management, as part of an Integrated National Financing Framework -- Capital account management aims to limit speculative inflows and currency mis-matches during economic booms, and minimize outflows during crises. For measures to be effective and allow for counter-cyclical management of boom and bust cycles, there is a case for developing capital account management frameworks. As highlighted in the 2019 Financing for Sustainable Development Report (FSDR), this could be achieved by incorporating capital account management techniques, along with macroprudential regulations, into integrated national financing frameworks (INFFs). By making capital account management part of INFFs, countries are also able to strengthen coherence between capital account management and macroprudential policies. Such frameworks would also allow countries to better manage inflows during boom periods, thus reducing the need to impose potentially more costly controls on outflows during economic slowdowns. Such tools must also be monitored and recalibrated to avoid a loss of effectiveness if market conditions change.

- **Risk sharing instruments to cushion and build resilience to external shocks.**

Other mechanisms to help countries cushion and build resilience to external shocks include state-contingent debt instruments, e.g., hurricane clauses that allow standstills to debt servicing in the case of an external shocks; insurance and insurance-type mechanisms, including expanding regional insurance facilities and diversifying across funds through re-insurance or a public fund (see the *2018 Financing for Sustainable Development Report*); and hedging mechanisms, including a diversified approach to currency risks (see the *2020 Financing for Sustainable Development Report*).

Other options

- **Central bank currency swaps**

The network of major developed country central banks, led by the United States Federal Reserve, have extended central bank swaps to some developing countries (Brazil, Mexico, Republic of Korea, Singapore), and the Bank of Japan have extended as a bilateral swap agreement with the Bank of Thailand. These swap lines are intended to prevent foreign-exchange liquidity from drying up. The Group could explore the criteria that determine which developing countries can benefit from these swap lines; the amount of the swap line relatives to the amount of capital outflows; and the potential impact of these swap lines on interest rate spreads and exchange rates. It could also explore a potential broadening of these swap lines to include regional monetary arrangements (such as the Chiang Mai Initiative Multilateralization).

- **Temporary repo facility**

The United States Federal Reserve has set up a temporary repo facility with foreign central banks (FIMA Repo Facility), where foreign central banks can temporarily exchange their US treasury securities against US dollars. According to the Fed, this facility should help support the smooth functioning of the US Treasury market by providing an alternative temporary source of US dollars other than sales of securities in the open market. The Group could explore the extent to which this facility has been used and its impact on capital flows, interest rates and exchange rates. It could also explore its potential impact on the desire of developing country central banks to self-insure by accumulating US treasuries as foreign-exchange reserves.

- **IMF lending facility**

The IMF lending facility has been made available since the global financial crisis, and recently changed. The Group could explore the options regarding the use of this and explore reasons why some countries have not used it in the current crisis.

ANNEX: Financing for Development Outcomes

Many of the areas discussed above build on existing international commitments in Financing for Development outcomes: the *Monterrey Consensus (2002)*, *Doha Declaration (2009)* and *Addis Ababa Action Agenda (2015)*.

Member States committed to:

- endeavour to design policies, including capital market regulations where appropriate, that promote incentives along the investment chain that are aligned with long-term performance and sustainability indicators, and that reduce excess volatility associated with portfolio investment (Addis Ababa Action Agenda, para 38).
- enhance global financial and macroeconomic stability and prevent and reduce the risk and impact of financial crises, including by strengthening international coordination and policy coherence (Addis Ababa Action Agenda, para 105);

They also acknowledged:

- the need for keeping under review the ***allocation of Special Drawing Rights*** (SDRs) for development purposes (Doha Declaration, para 73);
- the supportive ***role of macroprudential*** and, as appropriate, ***capital flow management measures***, for dealing with risks from large and volatile capital flows (Addis Ababa Action Agenda, para 105);

- the importance of strengthening the permanent international financial safety net and urged the IMF to continue its efforts to ***provide more comprehensive and flexible financial responses*** to the needs of developing countries (Addis Ababa Action Agenda, para 107).