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Policy brief

RESETTING THE GLOBAL FINANCIAL SAFETY NET FOR THE COVID-19 RECOVERY

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ABSTRACT

The uneven post-pandemic recovery brings great challenges for global financial stability and sustainable growth. To meet the challenges ahead, we propose to reset the Global Financial Safety Net designated to provide financial assistance for countries in need in the following aspects: (1) boost the use of the IMF Special Drawing Rights, (2) update the IMF's financing arrangements; (3) broaden the coverage and enhance the role of Regional Financial Arrangements; (4) coordinate national policies to mitigate negative effects of spillovers; and (5) align GFSN with the Sustainable Development Goals and the Paris Climate Agreement.

CHALLENGE

Due to the Covid-19 pandemic, the year 2020 saw the sharpest economic downturn since the Great Depression. In 2021 the world economy is showing signs of a broad albeit uneven recovery. The existing gaps of vaccination rollouts, economic fundamentals, and varying monetary and fiscal responses in different countries pose challenges in the areas of financial stability and solid growth worldwide. In particular, many emerging markets and developing countries that are lacking policy options in coping with uncertainty and spillover effects from advanced economies are desperate for liquidity support. Additionally, several debt-laden low and middle-income countries are facing difficulties of refinancing and are at risk of default.

The COVID-19 pandemic and its subsequent economic impacts pose great challenges for the Global Financial Safety Net (GFSN). The GFSN is a network comprising central bank swap lines from key currency-issuing nations, financing from the International Monetary Fund (IMF) and regional financing arrangements (RFAs), national foreign reserves in hard currencies, capital flow management measures, and a loose ad-hoc system for sovereign debt restructuring. Such a multi-layered network provides safeguard for global financial safety through international cooperation in which international financial institutions, such as the IMF, are in the center, and the G20 countries play a key role in prioritizing tasks and guiding principles based on consensus.

However, multilateral lending has been minimal during the COVID-19 pandemic. Despite enhancements and the expansion of financial support and lending policies, countries overwhelmingly relied on private-sector financing. Bilateral swaps were also important for countries that had access to them. What is more, the GFSN Tracker suggests that poorer countries and regions are under-insured. (Kring et al. 2021). Inequalities in access and available short-term financing point to the uncoordinated state of the GFSN (Mühlich et al. 2021). Thus, it is imperative that multilateral institutions strive to maintain choice and competition in the GFSN.

In the post-pandemic era, the challenge for the G20 is to reset the GFSN so that it can identify early signs of financial fragility and provide sufficient support for the countries in need of liquidity to tackle balance of payments problems and debt crises, as well as to manage the long-term challenges of climate change that entail the mobilization of massive investments in the years to come.

PROPOSAL

In order to continue to respond to post-pandemic challenges and to bolster a strong and sustainable recovery, this policy brief makes the case for actions to reset the GFSN through proposals to boost the use of the IMF Special Drawing rights (SDRs), reform the toolkit of the IMF, enhance the function of RFAs, strengthen policy coordination and capital flow management frameworks, and coordinate international financial institutions on sustainable development to respond to the climate challenges. Our proposals are as follows.

BOOST THE USE OF IMF SPECIAL DRAWING RIGHTS (SDRS)

The agreement to issue US$650 billion dollars in SDRs is a significant advance in reinforcing the GFSN to manage the ongoing crisis. Close to two-fifths of the new SDRs would boost the reserves of developing countries. It remains to be agreed how the unused SDRs, particularly from developed countries and China, would be lent or donated to special funds to support low-income countries through the Poverty Relief and Growth Trust (PRGT). Middle-income countries have correctly argued that a parallel fund should be created to support them. In both cases, financing from these funds should come in the way the emergency credit lines have been managed through the crisis: rapid approval and no conditionality (see below). Some of the new SDRs could also be used to increase the resources of RFAs that support low and middle-income countries (Gallagher, Ocampo & Volz 2020).

Beyond crisis management, it is essential to reform the SDRs, which remain one of the most underutilized instruments of international co-operation. Two important reforms should be on the agenda. The first is to eliminate the dual IMF accounting (regular and SDR accounts), which is the reason why most SDRs remain as just IMF accounting records. If the two accounts are consolidated, unused SDRs could be considered as deposits by countries in the Fund, which the institution can use to finance its programs. The second is to discuss the possibility of increasing the share of developing countries in the allocation, as these countries have a larger demand for foreign exchange reserves and are therefore the most important users of SDRs. This could be done by including the demand for reserves as an additional criterion for SDR allocations, along with IMF quotas (Ocampo 2017, ch. 2; Ocampo 2021).

UPDATE IMF'S FINANCING ARRANGEMENTS

The COVID-19 pandemic and the response to its economic effects highlights a number of inefficiencies, inequities, and shortcomings that should be remedied to effectively mitigate the economic effects of the pandemic. Some experts and the IMF staff itself have advocated for the IMF to develop a multilateral swap mechanism that scales up the capacity of swap networks already in operation across the global financial system. Truman (2021) outlines a framework for a central bank-financed multilateral swap mechanism through the

IMF that helps to augment the IMF's limited resources through the provision of temporary liquidity assistance. This could be established through highly structured, short-term central bank loans to the IMF, whereby "a group of central banks or central banks alone or governments with, or backing their central banks would commit to providing unlimited financial resources to the Fund in fixed proportions agreed on in advance upon receiving a request from the IMF" (Truman, 2021, p. 26).

A major issue in relation to the IMF financing arrangements is also to reform the IMF's access limits and surcharge policy. The surcharges increase the cost of financing when the loans exceed a certain proportion of a country's quota or when loans have been outstanding for more than a certain period. These surcharges affect in particular middle-income countries and, as the G24 has argued, following the views of other analysts (Gallagher 2021), should be suspended to support the recovery of these countries, and hopefully permanently eliminated.

The IMF credit lines that were more broadly used by developing countries last year were the emergency credit lines – the Rapid Credit Facility and the Rapid Financing Instrument. Although theses credit lines are small (a maximum of one country's quota), they had two basic advantages: rapid approval and no conditionality. For these reasons, the IMF should double these credit facilities in 2021.

Additionally, the IMF should pivot away from pro-cyclical policy advice and ensure that emergency liquidity is countercyclical and allows governments to "identify fiscal space through progressive policies to finance inclusive and sustainable development." At a time when the global economy is facing the challenge to respond to an uneven recovery, 154 countries are projected to begin a process of fiscal consolidation in 2021 (and 159 by 2022). Instead, the IMF should encourage member states to make countercyclical investments that would "help restore full employment and promote long-term growth" (Ortiz & Cummins 2021, pp. 61-65).

BROADEN THE COVERAGE AND ENHANCE THE ROLE OF REGIONAL FINANCIAL ARRANGEMENTS (RFAS)

The outbreak of the Covid-19 pandemic highlights fact that the IMF, with its wide coverage of membership and rapid financial assistance, remains the predominant multilateral financing source for most countries. Confronted with the shock of the pandemic, the RFAs fell short in providing liquidity in member countries and were significantly underutilized (Mühlich et al. 2021). Factors behind how a country chooses among different layers of GFSN indicate that the size of available funding, variety of tools, constraints on the fiscal use of financing facilities, and efficiency within the RFAs may have been a deterrent to their use by member countries (Xiong & Gao 2021). Conditionality and links to IMF conditionality have also been major deterrents.

The importance of the RFAs in GFSN has been widely recognized. In recent years, significant steps have been taken to increase the resources and scope of RFAs (Kring & Gallagher 2019). That said, significant inequities remain in the coverage of the GFSN, most notably for emerging markets and developing economies (Mühlich et al. 2021). The most recent development was the amendments to the Chiang Mai Initiative Multilateralization (CMIM) that came into effect on March 31, 2021. The CMIM has now institutionalized the use of member countries' local currencies in addition to the US dollar for funding, and increased the portion that is de-linked from the IMF supported program from 30% to 40% of each member's maximum arrangement amount (AMRO 2021). This development has enhanced the function of the CMIM and consolidated its supplemental role to the IMF.

However, further steps should be taken in face of the emerging challenges posed in the post-pandemic recovery. First, considering the demand for international financing from concerned countries in the post-pandemic, the RFAs should further optimize their lending toolkits and funding policies so that they complement those of the IMF. Second, in the area of surveillance, the RFAs should, based on their respective institutional advantages, scope of membership, and regional specificities, join hands with the IMF to form an integrated global economic surveillance framework to ensure global financial stability. Thirdly, the Policy Coordination Instrument (PCI) of the IMF should be further improved so that it could perform as the bridge between the IMF programs and the funding of the RFAs. In any case, there should be full respect for the autonomy of the RFAs and their decision-making processes.

COORDINATE NATIONAL POLICIES TO MITIGATE NEGATIVE EFFECT OF SPILLOVERS

As expansionary monetary and fiscal policies were adopted to support the economic recovery in most countries, some economies saw signs or risks of inflationary pressure. The economic consequences and spillover effects are compelling for emerging markets and developing economies in the circumstance of mixed news coming alongside uneven economic prospects, rising inflation expectations, and possible central banks' policy tightening in the advanced economies (IMF 2021). To mitigate the negative policy spillover, clear and regular communication among major central banks is needed. The Fed set an example of being transparent in its policy making based on a forward guidance approach. The central banks in G20 countries should set a regular schedule for communications to avoid sharp turns of market expectation caused by divergent policy moves.

Also, countries that are lagging in vaccine rollouts and still struggling with economic fallout due to the pandemic are facing additional volatilities generated by capital outflows and depreciation of their currencies. To maintain financial stability, capital management policies ranging from macro-prudential measures to temporary capital controls are crucial. As those measures are mainly carried out at national level, it is necessary for G20 countries to explore potential areas for cooperation, based on an update of the IMF framework of capital flow management measures (CFMMs).

ALIGN GFSN WITH THE SUSTAINABLE DEVELOPMENT GOALS AND THE PARIS CLIMATE AGREEMENT

A key challenge that needs to be addressed with urgency is to "climate-proof" the GFSN (Volz 2020). Climate change is increasingly recognized as a macro-critical issue – i.e. crucial to the achievement of macroeconomic and financial stability, which is at the core of the mandate of the IMF as well as RFAs (Volz & Ahmed 2020; Gallagher et al. 2021; Volz 2021). Climate vulnerable countries face considerable macrofinancial risks stemming from the physical and transition impacts of climate change, threatening debt sustainability, worsening sovereign risk, and harming investment and development prospects (Volz et al. 2020).

The IMF and RFAs can play important roles in supporting climate-vulnerable countries in mitigating and managing climate-related macrofinancial risks, leveraging opportunities from climate policies to boost growth, investment and resilience. While the IMF's attention to climate issues has increased markedly, including through research produced by IMF staff, the Fund has been rather slow in addressing climate-related macrofinancial risks in its operational work, comprised of surveillance, technical assistance and training, and emergency lending and crisis support (Volz 2020; Gallagher et al. 2021). RFAs have to date ignored the threats of climate change.

Climate-vulnerable countries have voiced their desire for more support from the IMF in addressing climate risks and vulnerabilities (Volz & Ahmed 2020). In particular, the IMF needs to integrate climate risk analysis in its surveillance activities, including Article IV consultations as well as Financial Sector Assessment Program assessments and Debt Sustainability Framework analyses conducted with the World Bank. The Fund has now announced that it would do so. Given the urgency, it will need to act swiftly and mainstream climate across its operations. The IMF will also need to scale up its technical support for member countries, and explore options for developing its toolkit for climate emergency financing.

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