Policy Brief

SHARPENING THE PROFILE AND SCOPE OF THE GLOBAL FINANCIAL SAFETY NET FOR BETTER PERFORMANCE AND GOVERNANCE OF THE FINANCIAL SECTOR

Task Force 7

International Finance and Economic Recovery

SHARPENING THE PROFILE AND SCOPE OF THE GLOBAL FINANCIAL SAFETY NET FOR BETTER PERFORMANCE AND GOVERNANCE OF THE FINANCIAL SECTOR

Task Force 7

Evgeny Vinokurov (Eurasian Fund for Stabilization and Development)

Artem Levenkov (Eurasian Fund for Stabilization and Development)

Gennady Vasiliev (Eurasian Fund for Stabilization and Development)

Abstract

The COVID-19 pandemic has highlighted the need for better global risk management, availability of resources and coordination among multilateral and bilateral donors. In this policy brief, the authors suggest enhancing the concept of the Global Financial Safety Net (GFSN) to better address these issues. They put forward the concept of an enlarged GFSN by including bilateral sovereign financing and a portion of multilateral development banks' financing. This would help achieve better accountability and more efficient coordination among various financial institutions and their shareholders.

Challenges

International financial institutions play an increasingly important role in the development of the financial sector and in assisting countries with macroeconomic stabilisation. The scope of instruments and institutions that assist governments to achieve stabilisation is growing constantly. The Global Financial Safety Net (GFSN) is constantly evolving. The Bretton Woods institutions emerged out of the need for a global financial architecture after the World War II. The 1998 Asian crisis incentivised the growth of the regional component of the global system. The 2007-2008 global financial crisis (GFC) highlighted the need for more flexibility for the GFSN to address liquidity shocks and financial contagion (e.g., Helleiner and Pagliari, 2011; Nelson and Katzenstein, 2014). Since the GFC, the system of financial institutions that provide stabilisation support has also been evolving, and by the time of the COVID-19 outbreak it was much larger than the conventional concept of the GFSN (Vinokurov et al., 2021).

We observe in the GFSN conceptual and coordination issues that may lead to its underperformance. First, the GFSN does not encompass multilateral development bank (MDB) and bilateral sovereign borrowing operations. Second, there is a convergence of mandates within international finance institutions (IFIs) that were initially focused either on crisis response (like the International Monetary Fund) or on development policies (like MDBs). Also, MDBs are moving away from their core tasks (development finance, poverty alleviation and infrastructure financing), while the IMF is shifting towards a broader economic development agenda. We argue that the convergence of IFIs' mandates and the widening of the resource base for financial support may lead to a higher risk of facility shopping and weaker development momentum.

This raises the question of coordination among the IMF, MDBs and other donors. For example, the Group of 20 puts the IMF at the centre of the GFSN. Coordination is framed by IMF–regional financing arrangements (RFAs) and IMF– MDB principles. The G20's IMF–MDB principles (2017, 2021) state that MDBs encourage countries that are experiencing a balance of payments (BoP) crisis to pursue the IMF programme. At the same time, MDBs provide BoP-like funding, especially for low-income countries (LICs). Despite the G20's efforts to enhance collaboration (G20 IMF–MDB principles, G20 GFSN-related statements), there is a gap between the IFIs in their coordination of financial and policy support activities, both in crisis and off-crisis periods.

From the shareholders' point of view, the convergence of IFIs' mandates may complicate optimal allocation of resources to support resilience and sector development, including in the financial sector. This may then negatively impact the GFSN as a system and resource allocation.

Furthermore, donors should better address the assessment of financial stability risks as part of overall macroeconomic stability and consolidate their policy advice in the financial sector agenda. Donors may leverage more on Financial Stability Board work and standards in their risk surveillance and policy recommendations on the financial sector. This may enhance financial system governance and increase resilience.

The G20 has repeatedly committed to strengthening the GFSN (G20, 2021), while the GFSN's shortcomings are noted (IMF, 2016). The major challenge for the G20 is achieving better coordination among its elements in the view of both recipient countries and the IFIs' shareholders. Unaccountable GFSN elements may lead to an unrealistic assessment of the adequacy of the GFSN's resources, and may also increase the possibility of facility shopping, with subsequent weak conditionality. All this may distort development and stabilisation efforts.

Proposal

The GFSN is responsible for providing stabilisation support to countries. It is conventionally described as an international multilevel system of financial mechanisms and institutions with four elements: countries' reserve assets (IRAs), central bank bilateral swap arrangements (BSAs), RFAs, and the IMF at the centre (e.g., IMF, 2016; Denbee et al., 2016; Scheubel and Stracca, 2019).

The safety net is expanding rapidly according to the conventional definition, with relative changes in the firepower of its elements. While the IMF's resources are growing and the Fund continues to be the central element of the GFSN, other institutions are also strengthening their roles. For example, regional financing arrangements including the Arab Monetary Fund (AMF), the Chiang Mai Initiative Multilateralisation (CMIM) with its Analytical Macroeconomic Research Unit (AMRO), the Eurasian Fund for Stabilization and Development (EFSD), the European Stability Mechanism (ESM) and the Latin American Reserve Fund (FLAR) are actively building their stabilisation financing potential and policy frameworks. Besides, institutions and activities outside the scope of the conventional definition of the GFSN are increasingly affecting the stabilisation financing landscape and available resources.

When comparing this GFSN concept with historical data and instances of crises, the authors observe that the current representation of the GFSN does not fully correspond to the actual availability of financial resources (Vinokurov and Levenkov, 2021). We also find several shortcomings, such as uneven coverage and insufficient and unpredictable access to financing. For instance, the GFSN does not allow support for all income country groups to respond adequately to a global liquidity crises, as demonstrated by the COVID-19 pandemic (Mühlich et al., 2022). At the same time, the GFSN remains underutilized during the pandemic (Stubbs et al., 2021).

To tackle these developments, we therefore suggest the concept of an enlarged GFSN, expanded through the inclusion of two new elements: MDBs and bilateral sovereign budget support. MDBs are increasingly becoming a key source of external budget support for sovereigns. Furthermore, bilateral sovereign financing should be incorporated into the GFSN in order to better reflect its firepower and focus attention on the issues of coordinating this instrument, availability of data and reasonable economic conditionality of the bilateral arrangements.

TO EXPAND AVAILABLE GFSN RESOURCES BY INCLUDING MDB LOANS AND BILATERAL SOVEREIGN ANTI-CRISIS SUPPORT IN THE GFSN FRAMEWORK

Policy-based financing from the MDBs as well as bilateral financial support should be considered very important additional sources of macrostabilisation support.

Since economic shocks can significantly influence the effectiveness of development policies, maintaining financial and economic stability is a focus of MDBs. Although MDBs, in a strict legal sense, are development institutions rather than stabilisation mechanisms, *de facto* they increasingly play the latter role as well. Stabilisation financing has become a significant part of MDB's agenda, especially in LICs. A recent joint RFA study indicates that during the COVID-19 pandemic, several major MDBs have provided rapid budget support facilities (RFA Joint Study, 2021), including the African Development Bank (AfDB), the Asian Development Bank (ADB), Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB). For instance, in Eurasia the MDBs may be compared with the IMF and RFAs in their level of stabilisation support for Kyrgyzstan, Tajikistan and Kazakhstan. The MDBs' financing for stabilisation support may be considered a substitute or supplement to the IMF programme. During 2009–2019, the World Bank and the ADB were the most active MDBs in the EFSD region of operations: their crisis and stabilisation financing accounts for approximately 5 percent of total stabilisation support for Armenia, Belarus, Kyrgyzstan and Tajikistan. Although the financing provided by MDBs is significantly lower than that of core GFSN institutions, its assistance is significant both in absolute and relative terms. It has also been relatively evenly distributed over the years, which allows for almost constant interaction with states in the programme format (Vinokurov et al., 2020). In some crisis periods, the MDBs may be the key source of external budget support for some countries.

The MDB sources of liquidity provide additional means to counter economic shocks, but there are also risks from postponing the needed reforms by losing IMF programmes and/or other elements of the GFSN, where financing conditions may require more drastic measures compared with terms of the MDB budget support programmes. There may be different reasons why MDBs are not included in GFSN taxonomy yet. For instance, MDBs may not want to emphasize stabilization activities in comparison to their core developmental mandate. Furthermore, explicitly focusing on MDBs budget support may add to the moral hazard issue. Countries may delay necessary reforms often required in the IMF and RFA operations when alternative sources of liquidity are available.

Even though the MDBs are not formally included into the GFSN concept, they appear regularly on the G20 radar since its leaders' statements mentioned the World Bank and other MDBs along with IMF as the main providers of the resources to overcome the global financial crisis (Cheng, 2016; G20 Declaration, 2008). The IMF also included multilateral institutions - such as multilateral and regional development banks - in the overall adequacy assessment of the safety net (IMF 2016).

Apart from MDBs, bilateral support is a large source of anti-crisis financing in many regions around the globe while being the second essential large-scale element still outside of the GFSN. Countries provide bilateral support in the form of loans, debt restructuring, refinancing or write-off.

At the same time, bilateral credits might become a source of additional risk when a country accumulates excessive debt without a proper macro and/or adjustment framework underpinning a loan. Bilateral lending may also come with a hidden non-financial cost. Due to overall lower transparency of bilateral lending, it is more challenging to understand its pricing structures and underlying motives in comparison with the core GFSN elements, especially lending from the IMF and RFAs (e.g., Cheng et al (2020). The G20 has addressed many of these shortfalls through 2017 Operational Guidelines for Sustainable Financing (G20, 2017). However, the issue of motives for increasing transparency remains principally unexplored, thus significantly reducing practical application of the Guidelines.

We argue that bilateral sovereign financing should be incorporated into the GFSN in order to better reflect its firepower and to focus attention on coordination issues, availability of data and reasonable economic conditionality of bilateral arrangements. This is particularly important for LICs. This source is a substantial part of financing for countries with government spending below US$500 PPP per person, accounting for approximately 70 percent of all international funding (Coppard et al., 2013). Moreover, according to the IMF, even before the onset of the pandemic in 2020, about 50 percent of LICs and several emerging market economies were in or at high risk of a debt crisis, and the further rise in debt is alarming.

In 2020, the role of COVID-related bilateral debt restructurings grew markedly. The G20 put in place the Debt Service Suspension Initiative (DSSI) to temporarily pause official debt payments to the poorest countries, followed by the Common Framework to help these countries restructure their debt and deal with insolvency and protracted liquidity problems. The DSSI supported low-income countries throughout the end of 2021, including measures by the IMF and the World Bank. With sovereign debt risks remaining elevated and financial conditions tightening, bilateral sovereign financing requires a new approach when considering coordination of bilateral arrangements with the other elements of the enlarged

GFSN. To conclude, debt restructuring significantly complemented the GFSN firepower. Therefore, authors suggest to reflect bilateral support in the GFSN framework and in the G20 agenda in a more explicit and formalised manner.

An enlarged interpretation of the GFSN that goes beyond its four traditional elements simultaneously implies several advantages and risks. The advantages and disadvantages of this approach can be considered both in their global aspect and through the prism of donors' interests, as well as those of the recipient countries.

For recipient countries, the balance of pros and cons is unequivocally positive. Recipient countries have greater opportunities for stabilisation financing. They can draw on the variety of sources and conditionalities. On the other hand, there is a systemic risk of a weakening momentum of the necessary macro and/or institutional adjustments if donors do not coordinate on the core conditionalities.

For the system as a whole, the situation is much more complex, but the overall balance is also positive. First, most importantly, the pool of available resources for anti-crisis and macrostabilisation financing effectively becomes larger. Kring and Gallagher (2019) note the large amount of available liquidity in the world under the GFSN, about $12.8 trillion. On the MDB level, the authors identify an additional $1.2 trillion of available liquidity. The amount of MDB liquidity available is all the more significant because most GFSN resources consist of national reserves, the full use of which is impossible for all practical purposes (since it would necessarily trigger a currency crisis).

That is why it is important not only for the GFSN to increase the scope of available capital: there is also a need for better coordination among the various institutions and layers of the GFSN. Greater coordination helps participating institutions to converge on uniform approaches, which is crucial for urging recipient countries to undertake structural reforms. It will also help to prevent an unnecessary overlap of activities, ultimately protecting and strengthening financial systems.

Overall, the authors suggest enhancing the taxonomy of the GFSN elements by incorporating budget support facilities of the MDBs and bilateral sovereign borrowing arrangements, to improve coordination and maximise the effectiveness of the crisis response.

With the same purpose, the authors suggest that the MDBs - with the IMF support – should regularly report to the G20 on the budget support operations and similar activities. This may include the following information: volumes, shares in their financial envelopes, conditionalities and reasons behind extending financing in the form of budget support (instead of project financing).

TO ENHANCE COLLABORATION BETWEEN GFSN INSTITUTIONS ON TOOLKITS AND LENDING FRAMEWORKS AND THE IFIS' SHAREHOLDERS' STRATEGIES

This enlarged concept of the GFSN provides opportunities for better coordination between "core" and "new" GFSN elements. These opportunities include a more distinct and clear division of roles during crisis events and better information exchange (data availability).

Despite the growth in available resources in the GFSN, close coordination among its elements is required to increase its effectiveness. In support of this argument, Grabel (2019) notes that inconsistency and lack of coordination among financial institutions generates certain risks. GFSN institutions may pursue different goals, especially during times of crisis, thereby losing effectiveness of response.

For instance, RFAs and the IMF have already significantly strengthened cooperation through various activities, including consultations on economic developments and policies, joint research seminars, technical assistance missions, high-level dialogues, and test-runs. RFAs report to the G20 International Financial Architecture Working Group on their cooperation, including with the IMF. The IMF attaches great importance to interaction with MDBs, including those that perform budget support: the ADB, World Bank, Inter-American Development Bank and AfDB (IMF, 2018).

In terms of division of labour, we see that the core and new GFSN elements are converging with respect to the purposes of their activities. For instance, *de jure* the IMF and RFAs, on the one hand, and MDBs' mandates on the other are different according to the charters. However, *de facto* we see risks of overlap. MDBs are expanding their core activities (development finance, poverty alleviation and infrastructure financing) with crisis responses in the form of direct budget financing. This process may effectively reduce the scope of Sustainable Development Goals (SDGs) financing. Meanwhile, the MDBs provide indispensable support for development, and their portfolios show that development finance for SDGs forms the bulk of their project activities.

From that, we may conclude that the IMF and MDBs should strengthen their coordination framework to bring their interventions more into line with their core mandates. Theoretically, this may be achieved either by agreeing that institutions will rely on each other's expertise in confirming policy measures for their respective programmes, or by revising the MDB toolkit and crisis response strategies. In respect to other elements of the GFSN, we advise that RFAs be considered together with the IMF when determining the distribution of roles for crisis support. A higher degree of coordination would help participating institutions to converge on uniform approaches, and help prevent unnecessary and counterproductive competition and facility shopping by recipient countries. This would effectively strengthen the GFSN and the global economy. From the shareholders' point of view, this new GFSN concept and convergence of mandates may have further implications. A member-state would normally define its interest in participation in an IFI or any other form of international support for a development agenda and would then consider allocating its limited resources to this or that IFI based on the institution's mandate and perceived efficiency. When IFIs *de facto* expand from their core mandates, it may be difficult for the member-state to come to an optimal decision on the allocation of resources. That may then negatively impact the GFSN as a system.

The authors suggest that governments and IFIs conduct an assessment on the issues we have raised, including IFIs' mandates within the G20 or other high-level fora. The G20 update on IMF–MDB coordination principles are an important methodological step forward. If the updated principles are put into practice, they may assist in strengthening the cooperation between donors and governments and ensure continuity for the dialogue on programme measures. Therefore, further practical steps and close monitoring at the G20 level are needed to ensure implementation of the principles.

On data availability and quantification of GFSN resources, we suggest that a platform be introduced for GFSN statistics that will be directly provided by the institutions and administered by a trusted partner. Currently, this data is fragmented or has significant gaps. There are several important initiatives under way to address the problem, e.g., the GFSN Tracker (*gfsntracker.com*). The EFSD keeps a comprehensive database for its own region of operation based on the concept of an enlarged GFSN and encompassing all types of sovereign financing, including grants and technical assistance to sovereigns. This database may be further expanded with non-financial conditionality information that may assist donors in setting appropriate and coordinated arrangements.

The IFIs and the G20 should also look at the general framework of data sharing among GFSN institutions to avoid an overlap of data requests and unbalanced data sharing. This will assist in swift data sharing and reduce duplication of requests to member-states.

The G20 should also return to the issue of strengthening donor cooperation platforms. In many cases, donors self-organise to coordinate their activities. However, the effectiveness of this effort varies case-by-case. The G20 Eminent Persons Group on Global Financial Governance (2018) recommended that effective country platforms be built to mobilise all development partners, to unlock investments, and to maximise their contributions as a group, including by convergence around core standards. The authors suggest that the G20 return this issue to its agenda.

References

Cheng, G., “The Global Financial Safety Net through the Prism of G20 Summits”, Working Papers 13, European Stability Mechanism, 2016

Cheng, G, D Miernik and T Turani, “Finding complementarities in IMF and RFA toolkits”, Discussion Papers 8, European Stability Mechanism, 2020

Coppard, D., German, T. and Randel, J. Investments to End Poverty: Real Money, Real Choices, Real Lives. Bristol: Development Initiatives, 2013

Denbee, E., Jung, C., and Paternò, F. Stitching Together the Global Financial Safety Net, Bank of England Financial Stability Paper 36, 2016

Grabel, I. “Continuity, Discontinuity and Incoherence in the Bretton Woods Order: A Hirschmanian Reading”. Development and Change, 50(1): 46–71, 2019

G20, Declaration of the Summit on Financial Markets and the World Economy, November 15, 2008. http://www.g20.utoronto.ca/2008/2008declaration1115.html

G20, G20 Operational Guidelines for Sustainable Financing, 2017 https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/world/G7-G20/G20-Documents/g20-operational-guidelines-for-sustainable-financing.pdf?__blob=publicationFile&v=1

G20, Principles for Effective Coordination Between the International Monetary Fund and Multilateral Development Banks in Case of Countries Requesting Financing While Facing Macroeconomic Vulnerabilities, 2017 https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/world/G7-G20/G20-Documents/g20-principles-for-effective-coordination-between-the-imf-mdbs.pdf?__blob=publicationFile&v=1

G20, Finance Ministers and Central Bank Governors Communiqué, July 2021. http://www.g20.utoronto.ca/2021/210710-finance.html

G20, Rome Leaders’ Declaration, 2021 https://www.governo.it/sites/governo.it/files/G20ROMELEADERSDECLARATION.pdf

G20, Eminent Persons Group on Global Financial Governance, Making the Global Financial System Work for All. Report, October 2018. https://www.globalfinancialgovernance.org.

Helleiner, E. and Pagliari, ‘The End of an Era in International Financial Regulation? A Postcrisis Research Agenda’, International Organization, 65 (1), pp. 169–200, 2011

IMF, "Adequacy of the Global Financial Safety Net". IMF Policy Paper, 2016 https://www.imf.org/external/np/pp/eng/2016/031016.pdf

IMF, Coordination Between the International Monetary Fund and Multilateral Development Banks on Policy-Based Lending: Update on the Implementation of the G20 Principles, 2018 https://www.imf.org/external/np/g20/pdf/2018/082918.pdf

Kring, W. and Gallagher K., "Strengthening the Foundations? Alternative Institutions for Finance and Development". Development and Change 50(1): 3–23, 2019

Mühlich L, Zucker-Marques M., B Fritz, Kring W N. No One Left Behind? COVID-19 and the Shortcomings of the Global Financial Safety Net for low- and middle-income countries, DA-COVID-19 project, 2022

Nelson, S. and Katzenstein, P, "Uncertainty, Risk, and the Financial Crisis of 2008", International Organization, 68 (2), pp. 361–392, 2014.

RFA Joint Study,"Regional Responses to the Covid-19 Crisis: A Comparative Study From Economic, Policy, and Institutional Perspectives. A Joint Regional Financing Arrangement Staff project", 2021. https://efsd.org/upload/iblock/821/RFA-Joint-Paper-2021.pdf

Scheubel, B. and Stracca, L., What Do We Know About the Global Financial Safety Net? A New Comprehensive Data Set. Journal of International Money and Finance, vol. 99(C), 2019

Stubbs T., Kring W., Laskaridisde C., Kentikelenis A., Gallagher K., Whatever it takes? The global financial safety net, Covid-19, and developing countries. World development journal Volume 137, January 2021.

Vinokurov, E., Levenkov, A., and Vasiliev, G., "Global Financial Safety Net in Eurasia: Accessibility of Macroeconomic Stabilization Financing in Armenia, Belarus, Kyrgyzstan, and Tajikistan". EFSD Working Paper WP 2020/2., 2020. https://efsd.org/upload/iblock/b63/EABR_EFSD_WP_20_2_EN.pdf

Vinokurov, E. and Levenkov, A. ("The Enlarged Global Financial Safety Net". Global Policy Journal, Vol 12, Issue 1, February 2021. https://onlinelibrary.wiley.com/doi/epdf/10.1111/1758–5899.12906

Vinokurov, E., Levenkov, A., Vasiliev, G, and Potapov, S. "Evolution of Tools and Approaches within the Enlarged Global Financial Safety Net in Response to the COVID-19 Crisis" EFSD Working Paper WP 2021/1., 2021. https://efsd.org/upload/iblock/7d4/EDB_EFSD_WP_2021_1_EN.pdf