



Toward A More Resilient Global Financial Architecture

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The global economy is undergoing major structural shifts—increased multipolarity, greater financial interconnections, and ongoing transitions in advanced and emerging economies. These developments raise tensions and risks, underlining the need to strengthen the international monetary system. As one of the main platforms for cooperation on economic and financial policies, the G20 could continue to play an important role in enhancing the resilience of the global financial architecture.

Strengthen mechanisms for crisis prevention and adjustment

As economies continue to integrate, risks and vulnerabilities associated with multipolarity and interconnectedness need to be managed. Periodic episodes of capital flow volatility appear to have become a feature of the new global landscape. This can contribute to financial pressures and balance sheet mismatches, particularly in emerging market and developing countries (EMDCs), where financial markets are less developed. Moreover, debt ratios in advanced economies and emerging markets (EMs) have now reached an all-time high for the post-war era while external risks have sharply elevated external and public debt vulnerabilities in EMs and low income countries (LICs). Frameworks and tools that reduce the likelihood of a crisis and help countries adjust in the event of one should be developed and adopted.

Managing capital flows and financial stability risks

Capital flows bring benefits and risks. Steady inflows promote financial sector development, facilitate productive investment, and allow for consumption smoothing. However, large and volatile capital flow can pose challenges. Funding can dry up, markets can become illiquid, and asset prices can exhibit large swings.

Reforms should aim at strengthening policy frameworks to enhance their resilience in the face of large capital flow pressures. The Fund's institutional view on the liberalization and management of capital flows (IV) is increasingly recognized by authorities as a useful framework (IMF, 2012). Capital inflow surges should generally be met with an appropriate macroeconomic policy response, including by monetary and fiscal policy mix, allowing the currency to strengthen if it is not overvalued, and building foreign reserves if they are insufficient. In some cases, countries may also resort to capital flow management measures (CFMs) to support macroeconomic policy adjustment and safeguard financial system stability. In general, these policies should not substitute for warranted macroeconomic adjustment, and should be targeted,

transparent, temporary, and preferably non-discriminatory. Going forward, the Fund will review the experience of member countries with the IV, with a view to addressing emerging issues.

Multilaterally coordinated efforts can increase the effectiveness of national policies. A more consistent global approach to handling capital flows would improve policy effectiveness. But more work is needed to gauge spillovers, and the potential to minimize them by adopting policies that can achieve similar domestic objectives. In particular, a range of mechanisms can address cross-border issues, such as negative externalities from a lack of appropriate macroprudential action, potentially undesirable spillovers, leakages undermining the effectiveness of domestic action, and migration of activities from uneven frameworks across countries (IMF-FSB-BIS, 2016). Finally, continued efforts by the global community to close remaining data gaps are key for surveillance. In particular, better coverage, timeliness, and granularity of data on capital flows and external balance sheets are needed.

Macroprudential policies can be instrumental in helping to limit systemic risk from capital flows. They can strengthen the resilience of the financial sector to funding, contagion, and asset price shocks stemming from capital flow volatility, and certain MPMs may also attenuate capital flows more directly (in the latter case, they are also considered CFMs). But more work is needed to build national frameworks for macroprudential policies, which are in many cases still in early stages of development. The Fund will consider the potential for a more detailed articulation of the role of macroprudential policies in addressing macroeconomic and financial stability risks stemming from capital flows (see separate paper on *Increasing Resilience to Large and Volatile Capital Flows*).

Updating frameworks for assessing risks to debt sustainability

The LIC DSF framework needs to be updated. The reform will ensure it is fitting for the current and future environment, well-aligned with risks, and carefully balanced in its approach to signaling crises and avoiding false alarms. Preliminary work by staff, and external consultations, have revealed a number of issues with the existing framework, and have highlighted the need to:

- Develop tools that would help improve the accuracy of the framework in flagging risks and debt difficulties.
- Update the empirical model underpinning the derivation of debt thresholds to better reflect country specific information and to improve the accuracy of debt thresholds as predictors of debt distress.
- Refine the approach to assigning risk ratings.
- Strengthen the assessment of total public debt, including, if feasible, by deriving a risk rating for total public debt to be used alongside the external risk rating.

Exploring innovative crisis-prevention tools: state contingent financial instruments

The idea of sovereign state-contingent financial instruments (SCFIs) has been around for a while and remains appealing, but take-up has been limited. By tying a sovereign's net payment obligations to its payment capacity, SCFIs aim to reduce the likelihood/severity of sovereign debt crises and, more generally, provide countercyclical policy space in downturns.¹ SCFIs can thereby contribute to a more resilient international monetary and financial system. However, SCFIs have primarily been used in debt restructuring contexts (as sweeteners), or in the form of commodity hedges. Their issuance in normal times has remained limited, reflecting, *inter alia*, first-mover reticence on the part of sovereigns, and investor concerns about data integrity and model risk (e.g., in the case of GDP-linked bonds).

There are several reasons to take a fresh look at SCFIs.² The value of risk mitigation may be high as debt-to-GDP ratios have risen in many advanced and emerging economies. Uncertainty is elevated, both in the near and longer term (e.g., Chinese economy slowdown, climate-related risks). Some proponents have argued that SCFIs would make particularly good sense if they transfer risk across sovereigns as an ex-ante fiscal risk-sharing device. From the investor perspective, the prevailing low interest rate environment appears propitious to the launch of new investment products. Finally, the use of SCFIs in recent restructurings (Argentina, Greece, Ukraine and Grenada) merits analysis.

The IMF is currently exploring the role SCFIs can play in preventing/resolving sovereign debt crises. It will focus on the benefits of using such instruments alongside/relative to alternative tools (such as self-insurance, official support lines, and longer-term conventional debt) but also on the potential costs—such as the adverse consequences of risk migrating from, say, the sovereign to domestic banks; review of past experience with SCFI issuance, both in normal times and in restructurings; survey of issuer and investor appetite for different types of SCFIs; and identifying the role of other stakeholders. A Board discussion is expected in 2017Q1.

Building a more coherent global financial safety net

The global financial safety net (GFSN) needs further strengthening. The GFSN has expanded with the continued accumulation of reserves, rise of bilateral swap arrangements (BSAs) and regional financial arrangements (RFAs), and the overhaul of the Fund's lending toolkit. Nonetheless, challenges to its effectiveness in preventing and managing crises remain. The coverage is uneven, with sizeable financing gaps for many economies. It remains too costly,

¹ SCFIs that are "debt" instruments can be designed in a number of ways: for example, debt payments could be made a continuous function of a variable like GDP or commodity price (e.g. GDP-linked bonds); or could undergo a one-time adjustment if a certain pre-defined event occurs (e.g. sovereign co-cos and hurricane clauses). Examples of "non-debt" SCFIs include hedging products (such as commodity derivatives), and insurance instruments (such as cat bonds).

² IMF staff had made a push for growth-indexed bonds in 2004, but there was not sufficient support among issuers, investors, and G-8 leaders at the time. A 2011 paper focused on SCFIs for low-income countries.

unreliable, and conducive to moral hazard. Moreover, the growing relative importance of BSAs and RFAs—and the lack of coordination across the various GFSN elements—has to led to a more fragmented and uncertain GFSN.

Further enhancing the Fund's lending toolkit

The Fund can help fill emerging gaps in the current GFSN by strengthening its toolkit for crisis prevention. Despite a major overhaul of the Fund's lending instruments for crisis prevention, only a modest number of countries have used them. Explanations include unmet demand for short-term liquidity support and the still high political cost (stigma) associated with the Fund. The Fund is currently exploring the possibility to address these issues with a new instrument for precautionary financing that would provide a "standing" liquidity backstop to members with strong fundamentals and policies for use when hit by liquidity shocks.

Addressing fragmentation in the GFSN

In order to enhance the effectiveness of the GFSN, RFAs and the IMF need to strengthen cooperation. A 2013 IMF stocktaking of RFAs noted the limited formal guidance on modalities for IMF-RFA coordination (IMF, 2013). Since then, a number of initiatives have been launched to address these gaps. In 2016 the Fund participated in a CMIM test run, which should help better prepare for the event of a balance of payments financing request involving financing by both the Fund and CMIM. Further work on IMF-RFA cooperation is planned for 2017. Finally, the IMF is also exploring a policy monitoring instrument that could provide monitoring and signaling without financing, to help countries signal reform commitment and catalyze financing from RFAs, as well as other official and private creditors.

Keeping the Fund strong

The Fund should be adequately resourced to fulfil its role at the center of the GFSN. G20 Leaders expressed support for maintaining access to bilateral and multilateral borrowing agreements between members and the Fund, in line with the objective of preserving the IMF's current overall lending capacity, and called for broad participation of the Fund's membership, including through new agreements. Recent commitments under 2016 bilateral borrowing arrangements are welcome and additional commitments from existing and new creditors are encouraged. Preserving the Fund's lending capacity requires also the renewal of the New Arrangements to Borrow (NAB) as a standing backstop to the Fund's quota based resources.

The Fund and its membership are committed to concluding the 15th General Review of Quotas. Subject to approval by the Board of Governors, the IMFC supported the Managing Director's proposal to reset the timetable for completing the 15th Review by the Spring Meetings of 2019 and no later than the Annual Meetings of 2019. As a next step, the Board will develop a work program with clear markers toward achieving this goal. Among others, the 15th Review will cover the adequacy of quota resources over the medium term and the G20 should recommit its

support for a strong, quota based and adequately resourced IMF so that it can continue to play its role at the center of the GFSN.

Examining broader use of the SDR

The Fund is examining whether a broader role for the Special Drawing Right (SDR) could contribute to the smooth functioning of the international monetary system (IMS) and help to strengthen the GFSN. The analysis will focus on identifying gaps and market failures in the IMS that the SDR could help address. Specifically, it will examine the evolution and economic role of the SDR in its three concepts—the official SDR (O-SDR), the market SDR (M-SDR), and the SDR as a unit of account (U-SDR)—and the complementarities between them, if any.

- *O-SDR.* The work will aim at identifying any gaps and market failures in the supply and demand of international reserves, and evaluate whether a composite reserve asset such as the O-SDR could potentially address those issues.
- *M-SDR.* The analysis will examine whether widespread use of the M-SDR would contribute to the overall stability of the IMS. It will identify advantages and disadvantages to developing this market from the perspective of market participants. It will also examine the necessary market infrastructure and the role of the official sector in developing deep, liquid M-SDR markets.
- *U-SDR.* Finally, the analysis will explore the potential for broader use of the SDR as a unit of account for statistics, financial statements, and the pricing of transactions, and the impact this could have.

References

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