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What the IMF can do now to confront COVID-19

By Ramin Toloui

KEY TAKEAWAYS

- Forceful actions by the IMF and World Bank are imperative to address the worst global economic shock since the Great Depression.
- A new IMF Systemic Liquidity Facility could provide $100-200 billion in critical financing to cushion the blow to vulnerable emerging markets.
- By calibrating borrowing limits on a sliding scale proportional to credit risk, such a facility could disburse funds rapidly, equitably, and at scale.
- Rapid action commensurate with the emergency can limit unnecessary collateral damage, making the larger job of stabilization and recovery easier.

The IMF projects that COVID-19 will cause the worst economic downturn since the Great Depression. A crisis of that magnitude demands a commensurately forceful response. As the IMF and World Bank convene this month, will global financial leaders rise to the challenge?

The good news is that the IMF has already expanded existing rapid financing mechanisms to make available an expected $100 billion to countries in need, as well as extended debt relief to 25 of the most vulnerable nations.

Unfortunately, other IMF initiatives being developed are simply not ambitious enough.

A case in point is the short-term liquidity line currently under consideration. The goal is to expedite support to countries with strong policies coming into this crisis. Rather than having to negotiate programs with detailed conditionality, such countries could draw IMF assistance swiftly to help manage the fallout from sharp capital outflows, which reached an estimated $80 billion in March alone.

Emergency liquidity lines are the right initial response. Early action in an incipient crisis can forestall avoidable damage. But it appears the framework being discussed is based on a proposal developed by IMF staff several years ago. Under that plan, only a small number of countries would qualify, and those that do could only draw a modest 145 percent of their IMF quotas.

It is time to think bigger. The IMF should create a Systemic Liquidity Facility (SLF) that would allow a broader number of countries to borrow and increase the amount the IMF makes available.

Under the SLF, eligibility would be determined by objective criteria—namely, market-based credit default swap spreads for each country in the period preceding the crisis. The best-quality borrowers would be eligible to draw

250 percent of their IMF quotas, with access calibrated so that it phases out in line with the market's prior assessment of the country's credit risk. Financing terms would be at a penalty rate and short repayment period to discourage excessive use and encourage countries to tap capital markets as soon as possible.

To illustrate, Indonesia would be eligible to draw approximately $16 billion under the SLF to bolster its $120 billion in foreign reserves. That represents a meaningful addition to its first lines of financial defense to meet near-term demands for U.S. dollar liquidity.

There are several advantages to this approach. Objective criteria mitigate the potential that judgments are clouded by political or bureaucratic considerations. The sliding scale of access prevents an "all-or-nothing" cliff, making eligibility decisions less fraught. Calibrated access also makes it possible to simultaneously increase borrowing limits for the platinum-quality countries and include a larger number of other high-quality borrowers in the program.

The facility is designed to be executed rapidly yet equitably at scale, which is exactly what is needed during systemic shock. A heavy-use scenario would translate into $100 billion of additional IMF support through the SLF. In an extreme case—where large borrowers such as India tap the facility—demand could increase to around $200 billion.

A new Systemic Liquidity Facility of $100 to $200 billion is large, but well below the roughly $1 trillion in lending capacity the IMF has pledged to mobilize. Moreover, sizable potential usage is a feature not a bug of such a facility. A diminutive footprint doesn't move the needle in meeting the needs of the global financial system.

If overall IMF resource constraints do become a concern, policymakers could consider special mechanisms for financing the SLF that reflect its exceptional and short-term nature. For example, the world's major central banks—United States, Eurozone, China, Japan, and United Kingdom—might explore dedicated funding for the SLF via special swap transactions with the IMF.

While similar to swap lines that the Federal Reserve has established with individual central banks, this arrangement would have the benefits of sharing the burden of liquidity provision multilaterally and harnessing the IMF's institutional expertise in emerging markets.

Many countries will not be eligible for the SLF, and some that are may ultimately require financial assistance beyond what is available under this facility. In those cases, traditional IMF programs with policy conditionality reflecting the unique attributes of this shock are appropriate.

While a systemic liquidity facility is no cure-all, it does provide a key tool for addressing the first wave of this crisis. Acting quickly and at a scale that reflects the emergency can limit unnecessary collateral damage, making the larger job of stabilization and recovery easier.

That job starts with bold action this month.

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