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To: Members of the Executive Board

From: The Secretary

Subject: **Lending Strategy During the Pandemic and Beyond**

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INTERNATIONAL MONETARY FUND

# LENDING STRATEGY DURING THE PANDEMIC AND BEYOND

June 19, 2020

## EXECUTIVE SUMMARY

This paper sets out a lending strategy for the Fund over three stages of the crisis: containment, stabilization, and recovery. These stages are linked to the evolution of the pandemic and its economic impact, both of which may vary from country to country. The duration of each stage is inherently uncertain, and countries are likely to reach each stage at different times. The application of the strategy should therefore take account of country-specific factors.

The key messages are as follows.

(1) At the ***containment stage***, the Fund has been relying primarily on emergency financing instruments to provide quick support to affected countries. At the ***stabilization stage***, qualifying countries should consider moving to UCT-quality programs with review-centric conditionality to deal with uncertainty. For the ***recovery stage***, it is expected that Fund support would shift to medium-term program engagement, such as arrangements under the Extended Fund Facility (EFF) and the Extended Credit Facility (ECF), with structural reforms appropriate to the resolution of the member-specific balance of payments problems that also foster inclusive and "green" growth.

(2) Throughout all stages, the Fund would continue to use ***precautionary instruments*** to reduce risks of sudden stops and systemically destabilizing capital flow management measures (CFMs).

(3) In parallel, the Fund would assist member countries addressing significant debt vulnerabilities through further advancement of ***current debt initiatives***—the Catastrophe Containment and Relief Trust (CCRT) and the G20 Debt Service Suspension Initiative (DSSI)—and ***coordinated solutions for debt operations*** with bilateral and private creditors.

(4) To support these operations, the Fund should also lay the groundwork for increasing its ***resources***, while strengthening ***IT, and HR practices***. The proposed strategy falls generally within the existing Fund policies, but could entail a shift in the risk-taking by the Fund that warrants careful attention to ***enterprise risks***.

Approved By
**Martin Mühleisen**

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# CONTAINMENT STAGE

*Since early March 2020, pandemic containment measures have been put in place across the Fund's membership. These measures restrict economic activity, with some economies still in effective shutdown. During this containment stage, the Fund has focused on supporting members in containing the humanitarian and immediate economic fallout from the pandemic.*

**The Fund's approach to lending during the containment stage is guided by several considerations…**

**1. Recognizing the unique nature of the shock**. Many countries are facing a unique and multilayered crisis, comprising a health shock, domestic economic disruptions, plummeting external demand, capital flow reversals, and a collapse in commodity prices. The unique nature of this crisis—and the unprecedented uncertainty about its duration and impact—has rendered the calibration of standard Upper-Credit-Tranche (UCT) quality programs very difficult. Travel restrictions and the challenges associated with virtual missions have further complicated the design of Fund-supported programs.

**2. Emergency financing**. Faced with this unique situation of urgency and uncertainty, the Fund has swiftly provided emergency lending (RCF/RFI) that does not provide for ex post conditionality. This emergency financing can be provided when the member has a balance of payments (BOP) need that is expected to be resolved within one year without major policy adjustment being necessary, or if such adjustment is necessary but not feasible due to lack of capacity to implement a UCT-quality program. The RCFs/RFIs have helped the affected member countries address urgent balance of payments needs arising from the crisis, thus tackling the immediate public health crisis and the adverse economic impact. RCFs/RFIs are expected to be used as a bridge to UCT-quality programs that are designed to help the member solve its BOP difficulties and regain external viability, where needed. As of June 19, 2020, emergency financing requests have been approved for 64 countries, together with 6 augmentations of existing programs. On the administrative side, the procedures for emergency support have been streamlined significantly to allow for timely response to urgent requests. Where governance and corruption vulnerabilities are macro-critical, safeguards of accountability, transparency and control in RCF/RFI requests have been clarified to strike the appropriate balance between rapid financial assistance and safeguards against the risk of misuse of Fund resources.

**3. Debt relief for poorest countries**. The Fund quickly modified the CCRT to relieve the poorest member countries from the debt service to the Fund for up to 2 years. As of June 19, 2020, relief for the first 6 months until October 13, 2020 has been approved for 28 out of 29 eligible countries, and further relief will follow, subject to resource availability under the CCRT.

**4. Temporary increase in access limits.** The pandemic-triggered shocks have created large upfront needs for Fund support. Hence, annual and cumulative access limits under the RCF/RFI have been increased on a temporary basis. A Board paper proposing temporary increases in the *annual* access limits for the use of General Resource Account (GRA) and Poverty Reduction and Growth Trust (PRGT) resources is under preparation. These increases will provide space for many members to fully utilize the recent increase of the RCF/RFI access limits and/or receive more upfront support in a follow-up UCT-quality program. The case for adjusting *cumulative* access limits will be kept under review.

**5. Continued provision of precautionary support**. Use of the Flexible Credit Line (FCL), Short-Term Liquidity Line (SLL), and Precautionary and Liquidity Line (PLL) by countries with very strong or sound policy frameworks, as well as precautionary Stand-By Arrangements (SBAs) and Stand-By Credit Facilities (SCFs), would help boost confidence and reduce the risks of sudden stops and subsequent systemically destabilizing CFMs. Such arrangements have significant benefits for qualifying countries individually (as insurance against sudden stops) and as a group (as systemically damaging CFMs may be prevented).

**6. UCT-quality programs with due attention to uncertainty**. Where it is appropriate to engage under SBA, EFF, SCF, and ECF arrangements, recognizing increased uncertainty, it may be appropriate to re-phase access and undertake program design adjustments to handle uncertainty depending on specific circumstances of countries. Among other things, these include drawing out contingency plans for policy responses under adverse scenarios (see below).

**7. Tackling debt issues.** The pandemic has given rise to mounting and complex debt problems. The Fund is currently pursuing a multidimensional approach:

- *Addressing debt issues in Fund operations.* Work is ongoing to (i) further assist the G20 in operationalizing the G-20 Debt Service Suspension Initiative (DSSI) in conjunction with the World Bank Group (WBG), including by finalizing modalities for fiscal monitoring and answering questions by country authorities; (ii) specify the conditions necessary to move forward on country cases where debt is already seen as unsustainable, assessing the authorities' strategies to address their individual situations and facilitating countries taking the necessary steps if they so decide, including through debt restructuring; and (iii) clarify how to establish Fund safeguards both in cases with unsustainable debt and cases where debt sustainability is uncertain (including through adequate creditor commitments).

- *Improving the international architecture for debt resolution.* Efforts are underway to (i) enhance the capacity of creditor countries to manage debt crises and take effective debt restructuring decisions; (ii) establish a high-level advisory group of former policy-makers and experts in the debt area to provide external input for the Fund's sovereign debt strategy; and (iii) strengthen coordination across both official and private creditors to facilitate dialogue, share knowledge, and discuss broad-based policy responses to the sovereign debt crisis.

**8. Collaboration with International Financial Institutions (IFIs).** Staff continues to work closely with other IFIs, including on financial support, debt management, and the design of social protection and governance measures in lending operations.

# STABILIZATION STAGE

*As the acute stage of the pandemic tapers off, some of the overall uncertainty and the immediate financing urgencies would be resolved. Economies start to reopen although at different pace, while additional waves of outbreak remain a possibility. The macroeconomic outlook would remain uncertain, including on the temporary versus the persistent impact of the shock. Hence, the key challenge for Fund lending is how to respond in the face of inherent uncertainty.*

**During this stage, the Fund lending efforts would be guided by several considerations…**

**9. Moving to second wave, UCT-quality programs**. For most countries that request (additional) financing, a transition to Fund-supported programs would be appropriate as the urgency of balance of payments needs abate and/or designing UCT-quality programs becomes feasible. The possibility of using emergency financing remains if a country meets the relevant qualification criteria. Where market access is limited, countries should also continue to receive grant support and concessional loans from bilateral and other multilateral donors.

**10. Calibrating program design with focus on stabilization**. UCT-quality programs in this stage would be generally expected to focus primarily on macro stabilization within the first 12-24 months. They also need to include features that facilitate navigating a more uncertain environment. Extensive structural conditionality would generally be expected to be avoided unless deemed critical for achieving the program's objectives, and moreover because the true extent of the shifts in the structure of the economy would only start to be revealed as more sectors reopen.

**11. While program design and conditionality for the second-wave of UCT-quality programs will differ depending on country-specific circumstances and the type of facility being used, they are generally expected to have the following features**:

- *Use of adverse scenarios and contingency planning.* Given the high uncertainty around the baseline projections—particularly regarding key variables, such as BOP needs and debt—program design is generally expected to include a strategy to keep the program on-track to meet its broad objectives if risks materialize. Mindful of capacity constraints, staff and the authorities would be strongly advised to undertake a fuller discussion of risks to the program and develop detailed adverse scenarios and contingency plans. This collaborative process would place the authorities in a stronger position to respond to adverse developments.

- *Focus on short-term macro stabilization.* Programs would be expected to have greater focus on the shorter horizon (e.g., closer attention to financing needs and sources in the immediate 2-3 quarters), with policies particularly centered on stabilizing the economy, ensuring adequate priority spending, and safeguarding external stability in the face of possible foreign exchange and debt pressures. Structural conditionality may be warranted (in a selective and focused manner) in cases where structural policies are critical to meet the objectives of the program (e.g., to support achievement of fiscal targets while protecting social spending). In longer programs, broader policy objectives could be concretized once uncertainty abates.

- *Application of a more review-centric approach.* Heightened uncertainty could necessitate frequent revisions to macroeconomic frameworks, which in turn would render many quantitative targets impractical to implement. Conventionally, adjustors facilitated fine-tuning of program targets to changes in key assumptions, such as commodity prices or the external loan disbursements. However, with many key variables in flux, the usefulness of adjustors would be limited, likely involving overly complex specifications and raising the risk of misreporting. This heightened uncertainty would therefore argue for some rebalancing—moving towards review-centric conditionality, whereby program monitoring would shift towards a greater use of Indicative Targets (ITs) for quantitative objectives together with a smaller number of Performance Criteria (PCs).

- *Consideration of "unconventional/unorthodox" policies.* When conventional monetary and fiscal policies are inadequate to restore stability, or are not feasible, less conventional or so-called unorthodox policies (e.g., regulatory forbearance, as already under way in some countries, or administrative controls) could be considered on a temporary and case-by-case basis. It is well understood that these measures risk undermining hard-won gains in policy making and institution building, may set damaging precedents, and be hard to unwind. Thus, it is crucial for such policies to be considered only when the scope for conventional policies is exhausted, on a case-by-case and temporary basis, with clear exit plans and adequate safeguards.

- *Consideration of debt reprofiling.* When debt sustainability is uncertain, debt reprofiling could be considered outside of the Exceptional Access framework to limit fiscal austerity. As discussed in the 2018 Review of Conditionality, this could be a useful option, particularly if concessional official financing cannot be mobilized in sufficient amounts to restore debt sustainability and meet program financing assurances.

- *Capital flow management measures (CFMs).* Where appropriate, and consistent with the IMF's Institutional View, program design may entail use of CFMs in response to large capital outflows to help reduce external financing gaps and safeguard public resources.

**12. To operationalize these design elements, the existing Fund facilities could be adapted to accommodate above features, or alternatively, a new "pandemic" facility could be considered**.

- *Adapting program design within existing facilities.* One option is to accommodate the above design features within the Fund's existing facilities. For instance, this stage would entail greater use of SBAs than EFFs, and an increased focus on the initial stage of the programs in all types of arrangements, through modifications in program design features as elaborated in paragraph 11.

- *Considering a new lending facility.* As an alternative to the adaptation of programs under the existing facilities, a new "pandemic facility" could be created to incorporate the desired design elements and potentially reduce the stigma of approaching the Fund. Specifically, the new instrument could entail features, such as a 12-18-month duration to accommodate the features suitable at the stabilization stage, and a longer repayment period (5-10 years) given the likelihood of long-lasting scars from the crisis and prospects of subdued growth. Differentiating the facility as being specifically for countries' pandemic response could provide a cover for authorities to seek Fund support without political backlash. It should be noted, however, that with the exception of the long repayment period (relative to program duration), other features mentioned above could be achieved flexibly under existing instruments.[1]

**13. Continued emphasis on precautionary arrangements**. FCL/PLL/SLL arrangements with no/little ex post conditionality for qualifying countries would remain very useful, and precautionary SBAs and SCFs for other countries with potential BOP needs would be very helpful in the context of heightened uncertainty.

**14. Tackling debt issues**. Intensive monitoring of debt risks would continue as significant uncertainty and downside risks could give rise to increased solvency concerns. Further advancing the Fund's multi-dimensional approach to help the membership navigate a complex debt situation would be crucial. In particular:

- *Addressing debt issues in Fund arrangements.* The Fund would (i) continue to support the smooth functioning of the G-20 DSSI; (ii) prepare an assessment for the G-20, jointly with the WBG, on a possible extension of the DSSI into 2021; and (iii) support the resolution of debt crises in countries whose debts are newly deemed to be unsustainable.

- *Adjusting Fund debt policies.* Work would continue to adjust frameworks to better support enduring resolutions and handle growing problems in many emerging market and developing countries. To handle high economic uncertainty and provide time for official bilateral creditors to respond, the Fund could consider: (i) wider use of debt restructuring assurances invoking a two-step process (agreement to reprofile debt falling due in the short term combined with assurances about deeper debt restructuring within the program period) in combination with safeguards to protect the Fund if the second step is not forthcoming; and/or (ii) wider use of *Approval-in-Principle* procedures for programs.

- *Improving international architecture for debt resolution.* Staff would (i) continue to work with creditor countries to strengthen their capacity to make timely debt restructuring decisions when necessary; (ii) collaborate with the Paris Club and creditor countries outside the Paris Club to define procedures for their coordination; (iii) contribute to the design and promote state-contingent and value recovery instruments (with caps) to incentivize creditor participation in debt exchanges and reduce debt vulnerabilities after the crisis; (iv) promote the use of standardized term sheets, consent solicitation forms, and waivers to streamline the restructuring

[1] It could however prove challenging to argue for a longer repayment period, which suggests a protracted BOP problem, while envisaging a shorter program duration (12-18 months), which suggests that the BOP problem is of a shorter-term nature.

process and reduce transactions times and costs; and (v) assess whether there is a need for additional mechanisms that would limit the ability of holdout creditors to enforce their claims.

**15. Collaboration with IFIs**. Staff would continue to collaborate closely with IFIs on lending operations, including in financing and design of social protection policies.

**16. Promoting reforms to facilitate household and corporate debt resolution**. As temporary regulatory forbearance measures get phased out and businesses reopen, the extent of troubled loans would become clearer. If not resolved, nonperforming loans could create a vicious circle of stagnant growth and timid credit growth. Reforms to the national legal and institutional frameworks would be encouraged to ensure efficient and equitable corporate (including SOEs) and household debt resolution and special out-of-court restructuring mechanisms could be considered. This would support the reallocation of capital and labor to viable businesses.

# RECOVERY STAGE

*As economies stabilize and the shutdown eases, there would be more clarity on the impact of the crisis, including temporary versus permanent effects across different type of countries. That said, a reasonable assumption is that the crisis leaves long-lasting damage to output and debt levels, with significant distributional effects within countries. Many economies would require debt resolutions and/or adjustment programs that support employment, facilitate structural reallocation, and foster inclusive "green" growth.*

**The Fund lending operations would generally be expected to evolve as follows…**

**17. Shifting policy focus to structural policies.** To support external adjustment, arrangements of longer duration involving structural adjustments (EFFs/ECFs) would be considered, as appropriate, depending on country-specific circumstances. For countries that initiated EFFs/ECFs at the stabilization stage, program design would be expected to switch gears to structural priorities. Structural conditionality in shared and emerging areas is expected to be re-introduced at this stage. To provide more flexibility to authorities in an uncertain environment, programs can consider so called "floating tranches". In these cases, a portion of access would be made available not according to a fixed schedule, but once certain structural reform actions have been taken. This would give programs a better chance to remain on-track and meet their broader objectives and offers greater flexibility in the timing of challenging reforms.

**18. Unwinding unconventional policies.** Program design would be expected to shift away from such policies that were put in place temporarily during the earlier stages for crisis mitigation and management purposes.

**19. Reviewing the application of the review-centric conditionality.** As countries exit the stabilization stage, moving back to using more quantitative PCs for program monitoring would be underway, while as mentioned before, recognizing the country-specific circumstances in program conditionality.

**20. Adapting precautionary arrangements**. As elevated uncertainty abates, consideration would be given to adapting precautionary arrangements to the new environment— by reducing their access, or transitioning from FCLs to SLLs, where applicable, provided that the relevant qualification requirements are met.

**21. Further tackling debt issues**. The Fund would complete its agenda in the following areas:

- *Addressing debt issues in Fund operations.* The Fund would continue to address new solvency cases using the improved resolution processes created in the stabilization stage. In the event that the simultaneous handling of several new solvency cases stretch the ability of the existing case-by-case approach, a coordinated response led by the G20 and supported by the IMF, guided by the example of the DSSI, could be considered.

- *Adjusting Fund's debt policy framework to facilitate debt resolution.* The Fund's policy of lending into arrears policies would be reviewed to achieve greater clarity about the scope of preferred/senior creditors and discourage uncooperative holdout creditor behavior.

- *International architecture for debt resolution.* Initiatives that started during previous stages of the crisis would be further pursued.

**22. Collaboration with IFIs.** As before, staff will continue to collaborate closely with other IFIs, including on financing plans and structural measures. The recovery period could be an opportune time for Fund programs to help enhance the resilience of vulnerable economies to health and climate risks, including through promotion of macro-critical mitigation and preparedness measures.

# NEXT STEPS

**23. Extraordinary measures, to be followed by sustained efforts**. Since the onset of the crisis, extraordinary measures have been taken to respond to the needs of the membership, but further sustained efforts are needed to adapt the Fund's lending policies. If agreed, the Lending Strategy could be further operationalized through the following steps:

- Continuing fundraising for the CCRT and PRGT and monitoring the need for additional GRA resources (ongoing).

- Reviewing the PRGT financing model and associated lending policies to ensure that the Fund can respond effectively to the needs of LICs (July 2020 for first engagement with the Board).

- Proposing an increase in the normal annual access limits for GRA and PRGT (June 2020).

- Establishing the universe and conducting outreach to potentially qualified countries for FCL/SLL/PLL (ongoing).

- Updating financing gap exercises quarterly (ongoing).

- Moving towards completion of the reviews of the Fund's Debt Limit Policies (DLP) and DSA for market access countries, leading to Board adoption of the improved policies and methods (on-going).

- Helping find and broker workable technical solutions that facilitate private sector participation in the DSSI (ongoing). Developing terms of reference for an SDF (June 2020). Engaging the Board on debt related issues (July 2020).

- Including ex ante enterprise risk analysis in lending policy papers, as well as in papers for large and highly risky programs. Updating the Board on the current risk profile of lending (in the context of quarterly ORM reports).

- Discussing with stakeholders the trade-offs between financing versus debt operations/exchange rate adjustment/CFMs/other policy adjustments (on-going).

- Building on recent progress with reducing stigma and encouraging countries to seek Fund support as a follow-up to emergency financing.

- Addressing HR and budget constraints arising from increased program engagements.

- Finding reliable technological solutions for remote discussions with the authorities.

- Developing a contingency plan for lending operations (by September 2020). In a plausible event of a resurgence of Covid-19 later this year or an even more prolonged pandemic, the first two stages could be much longer than suggested in this note, requiring a more fundamental rethinking of the Fund's lending and financing capacities.

**24. Regarding enterprise risks, the lending strategy would mitigate some risks while raising others that need to be mitigated or accepted**. The strategy would address the Fund's strategic, lending, and reputational risks through its clear and consistent approach to lending that differentiates across the different stages of crisis and pays attention to country circumstances and financing needs. However, the strategy would raise/entail risks to programs, credit, resources, and budget by: absence of ex post conditionality (in FCLs/SLL and emergency financing), higher volume of lending amid uncertainty that complicates assessments of key safeguards (CTR, DSA), longer program engagement, and higher access limits. The strategy seeks to mitigate these risks by: flexibility in program design and conditionality, encouraging follow-up UCT programs where feasible, promoting contingency plans, and ex ante risk assessments. Residual risks would remain, including with respect to Fund resources, credit, and the budget. Their size and nature will be clearer when specific proposals are developed and implemented.

# ISSUES FOR DISCUSSION

**25.** Staff is seeking Board views on all elements of the proposed Lending Strategy, but would particularly welcome comments on the following:

(1) Do Directors agree that each stage of the crisis requires tailored solutions?

(2) Do Directors see a need for new Fund facilities to address the crisis?

(3) Do Directors agree with the general proposed shift to UCT-quality programs with review-centric conditionality and more parsimonious approach to structural conditionality at the stabilization stage, recognizing also the need for country-specific tailoring?

(4) Do Directors agree that precautionary arrangements should play a significant role to support emerging market economies during the containment and stabilization stages?

(5) Do Directors agree with the proposed approach to addressing debt issues?

(6) Do Directors agree with the proposed next steps?