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Statement by Mr. von Kleist and Mr. Buetzer on Fund's Pandemic Response: Options for Lending to Support Members During the Next Stage of the Crisis (Preliminary)
Executive Board Meeting
September 25, 2020

We thank staff for a comprehensive report and welcome the ongoing work on exploring options to deal with the challenges of the current crisis for the architecture of Fund lending and the design of Fund-supported programs.

We agree on the need to ensure that Fund lending is sufficiently tailored to deal with the development of the crisis and such that member countries' needs during the next stages of the crisis are adequately addressed in line with the Fund's mandate. At the outset, we would like to recall our general remarks from the last Board meeting on "Lending Strategy During the Pandemic and Beyond" on July 1st, namely that:

(i) **shifting from the provision of emergency assistance to regular UCT-quality programs,** based on the standard requirements for Fund assistance, is an urgent priority going forward;

(ii) **addressing structural reform and adjustment needs early on has become more, not less pressing in the current crisis to achieve a sustainable recovery;**

(iii) **the Fund's risk management deserves key attention which underscores the need for maintaining appropriate safeguards, including strong conditionality, and protecting long-standing principles and norms of Fund lending**, among them the revolving character of Fund resources, the catalytic role of Fund financing, and a solid assessment of a country's debt sustainability and capacity to repay based on realistic projections.

<u>Assessment of the current situation and existing lending framework</u>

The Covid-19 pandemic has triggered multiple shocks, giving rise to a deep, synchronized global downturn with extraordinary high uncertainty about the medium-

term outlook. Against this background, we agree with staff that cushioning the impact of the crisis through macroeconomic stabilization is the most important policy objective at the current stage. Depending on country-specific circumstances, this calls for a differentiated approach, including, where needed, a feasible, realistic macro adjustment and possibly debt operations.

At the same time, we do not subscribe to the view that "the extent to which structural reforms are needed, and the detailed content of the reforms will crystalize, only when uncertainty about magnitude and the direction of shifts in post-pandemic equilibria abates" (para. 11). Quite to the contrary, pre-existing structural weaknesses have been exposed and amplified by the crisis, for example in public financial management (PFM), social safety net gaps, but also concerning challenges to achieving greater economic diversification.

While we agree that, depending on country specific circumstances, the full extent of structural reforms required might become clear only once the economy is well on a recovery path, we also believe that the timely implementation of appropriately prioritised and sequenced structural reforms is key for a sustained recovery. Where necessary, particular consideration should be given to promoting good governance, anti-corruption measures, better PFM frameworks, and higher debt transparency, not least to safeguard the appropriate use of unprecedented amounts of financial assistance from the international community, as also lined out in our Joint Gray on the "Update on the Implementation of the Framework for Enhanced Fund Engagement on Governance" on July 1st. Selective and well-designed structural conditionality would not only assist countries in overcoming pressing short-term challenges and BoP needs, it would also support an inclusive and sustainable recovery over the medium term by enhancing countries' growth prospects and external position.

By contrast, backloading structural reforms risks to undermine the outlook for a lasting recovery, and the Fund should be careful not to send this message. This also relates to staff's scenario of a "fully self-reversing shock", which we consider as rather unlikely.

Given this assessment, we wonder to what extent there is an actual need for an adaptation of existing facilities or consideration of a new instrument/window to fill a perceived "gap" in the current toolkit. While we agree on the need for more contingency planning and some flexibility in program design in line with the heightened uncertainty, the existing Guidelines on Conditionality already leave sufficient room to address these needs in crisis times, including though the use of adjustors, quarterly program reviews, and if need be ITs instead of QPCs. *Regarding the design feature of a "broad menu of policy options" (para. 17, last bullet), we would be interested in some specific examples of what these could be. We understand that this feature can also be accommodated under the current guidelines already.*

Staff's main rationale for the presented reform options appears to be the perceived need for a "weaker link between the strength of policies and phasing of Fund

resources" (para. 18), on which we decidedly disagree. As noted above, strong policies are of the essence to address this crisis – in particular for countries seeking Fund support. Moreover, the notion that the provision of Fund financing needs to be commensurate with the policy strength of the underlying program constitutes a central and established tenet of Fund lending and a key safety features that should not be abandoned**.**

In sum, we are not convinced that the nature of the crisis calls for a departure from the Fund's traditional lending strategy. We do not see the case for reduced policy strength and structural reform measures at the front of a Fund-supported program combined with front-loaded access and longer repurchase periods. Weakening the Fund's lending policies seems neither in line with the acceptable risk levels of Fund lending, nor conducive to achieving a sustainable recovery of program countries from the crisis.

Assessment of the proposed reform options

At this point, we are not yet in a position to identify a preferable option, also given our doubts over the need for an overhaul of the Fund's lending architecture, and the not yet fully convincing design of the presented options.

Option 1 should clearly be excluded, as it would further postpone the transition to UCT financing and thus carries unacceptable risks.

To the extent that Option 2 implies a substantial adaptation of the existing instruments along the lines suggested in the staff report, we have strong reservations. The seal of approval that is associated with the Fund's "traditional workhorse facilities" must not be undermined. Preserving their credibility and integrity over the long-term is important at the current juncture and will be even more so as we move through the different stages of the crisis.

To the extent that a broad consensus were to emerge on the need for somewhat different lending practices that cannot be met under the flexibility already included in the existing instruments, ring-fencing, and a strong link to the temporary and highly extraordinary nature of the current pandemic crisis become key requirements.

Options 3 and 4 appear broadly suited to ringfence those changes in lending practise if they are foreseen as a strictly temporary measure and underpinned by a robust Sunset / Review Clause with a high majority threshold. Automatic expiration of such a new window / instrument should be foreseen sooner than after four years, given that such a horizon would surely go beyond the current juncture of exceptionally high uncertainty invoked to justify a new instrument.

Options 3 and 4 should also be modified to address our above-mentioned concerns on structural conditionality.

At the same time, it needs to be acknowledged that creating a new window or instrument will face a difficult trade-off between maintaining sufficiently high standards for its use to prevent facility shopping and containing risks to the Fund on the one hand, and on the other hand providing an attractive instrument that is taken up by members to support a sustainable recovery.

A danger, that is particularly pronounced with option 4, is that it may increase stigma for those countries that are not considered eligible for the new facility but instead have to resort to an EFF (or already have an EFF in place). Such countries could be perceived as "weak" whereas countries requesting the new facility could be perceived as "strong" with supposedly few structural weaknesses. The reputation of the traditional programs, which have served the membership well, could thus suffer, if those countries which were prudent enough to ask for an EFF early on would be punished, whereas latecomers would benefit. *Staff comments on this problem would be welcome.*

We would also be interested to learn more about the intended users of such a new window or instrument. In particular, if it is to exclude countries with "pre-existing imbalances" (under option 4, para. 37), we consider that it would be available for only a small proportion of the Fund's membership. At the same time, such countries without evident need for structural policy measures could be served by using SBAs first, possibly followed by a later transition to an EFF if needed in case the expected improvement in external conditions does not materialize.

Another key consideration is that the useful safety features (non-repeated use, presumption of even phasing and normal access, heightened requirements on debt sustainability) identified for Option 4 would also be accommodated under Option 3 and we would appreciate staff's comments on this.

PRGT Considerations

Lastly, we acknowledge the serious challenges faced by low-income countries in the current crisis. Concerning the PRGT and the potential need for a similar instrument, we consider that PRGT-eligible countries by their very nature already tend to display a greater need for structural reform measures, including institution building. Moreover, the objectives of PRGT-programs are different and have a stronger emphasis on growth and poverty reduction. As a result, the case for adjusting the PRGT lending framework appears weaker still.

We agree that possible options for PRGT lending are best explored as part of the review of concessional lending. Without pre-empting this debate, and as for the proposed changes to the GRA lending toolkit, we see a significant risk of facility shopping in case of a new instrument, if the criterion of "no pre-existing imbalances" is applied only loosely. Moreover, altering the architecture and balance of PRGT instruments can also have negative implications on the already fragile financing envelope. This calls for a high degree of caution, an eye on resource mobilization, and for carefully weighing advantages and drawbacks of reform options. It should also be acknowledged that there are other institutions specialized on providing support to LICs, and that these may be in a better position to provide financial assistance to address pandemic-related effects.