Briefing Paper

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Managing global liquidity through COVID-19 and beyond

Summary

- One surprise of the COVID-19-related economic shock has been the lack of a persistent international liquidity crunch. Policymakers have successfully scaled up emergency measures from the 2008 global financial crisis and have introduced temporary debt service relief for poor countries.
- However, the next phase of the policy response may be more challenging. In some countries, debt sustainability will need to be confronted. Monetary policy normalization, when it eventually happens, could lead to market volatility and tighter financing constraints.
- This briefing proposes international coordination on several fronts to address these and related issues. The first is for the IMF to undertake general allocations of Special Drawing Rights (SDRs) as a source of liquidity. A multilaterally managed trust could 'recycle' SDR allocations from countries that don't need them to those that do.
- The second proposal is to build on the G20's new common framework for sovereign debt restructuring, launched in late 2020. Enhancements should include stronger alert mechanisms and a comprehensive public debt repository.
- Third, the IMF should develop best-practice guidelines for normalizing economic policy as the effects of the pandemic abate, in conjunction with enhanced precautionary lending facilities.
- Finally, structural initiatives to deepen capital markets in developing economies should include: increased commitment to issuing sustainable bonds by the G20; and the use of securitization and credit guarantees to leverage the balance sheets of multilateral development banks.

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Introduction

Academics and other observers of the international monetary system have often noted in recent years an enduring fault line, despite the systemic reforms that followed the 2008 financial crisis, in the shape of a lack of institutional mechanisms to ensure sufficient liquidity in times of global financial stress. The unprecedented economic shock associated with the COVID-19 pandemic has again underlined the importance of developing such protections.

When economies around the world went into lockdown in 2020 as part of efforts to curb the spread of the virus, there were expectations in some quarters that an international liquidity crisis could ensue. Fortunately, it seems that such fears have not been realized to date. Apart from short-lived stress in US dollar markets in March 2020, global markets did not seize up in response to pandemic-inflicted financial pressures. And while capital outflows from emerging markets in that month set a historic record, no systemic liquidity crisis ensued.

This owed much to the speedy reuse and, in some cases, massive scaling up of many pre-existing policy instruments, drawing on a suite of strategies that might collectively be termed the 'global financial crisis playbook'. This was complemented by significant ad hoc policy innovations by central banks in both developed and emerging markets, as well as by the G20.

So far, so good. But more difficult issues lie ahead, as the economic toll of the pandemic is expected to be long-lasting, and as spending aspirations on healthcare (notably vaccines) and green infrastructure will be higher than ever, generating financing needs many countries may struggle to meet.

Given this context, this briefing paper identifies four issues that would benefit enormously from international cooperation – and that indeed may be intractable without it. These are: (i) addressing potential donor fatigue in liquidity provision; (ii) isolating liquidity problems from solvency problems (and dealing expeditiously and sustainably with the latter as such); (iii) anticipating the inevitable challenges when central banks start to normalize monetary policy (in some cases, such challenges will arise earlier); and (iv) making the task of 'building back' better and greener less insurmountable for developing countries.

The paper proposes the following ideas for consideration in response to these issues: (i) substantial allocations of IMF Special Drawing Rights (SDRs), to take over from the G20-sponsored Debt Service Suspension Initiative (DSSI); (ii) development of a more complete and transparent framework for sovereign debt restructurings, drawing lessons from previous failures to durably restore solvency; (iii) a playbook for dealing with policy normalization; and (iv) coordinated actions to spur the development of deep and liquid markets for emerging-market impact bonds and local-currency bonds.

A brief assessment of global liquidity in the 2020 COVID-19 shock

The economic shock caused by lockdown measures taken in key economies to contain the spread of COVID-19 was of unprecedented magnitude, but a financial crisis was averted in nearly all countries. This owed much to the significant risk-reduction measures adopted by banks in most countries following the last global financial crisis, and to the prompt reuse and scaling up of large parts of the policy playbook from that period. This included, in particular, balance sheet expansions by major central banks (on a much more massive scale than in 2008–09), the renewal of swap lines between the US Federal Reserve and major central banks (including, as in 2008, a handful of emerging-market central banks), and increases in IMF emergency relief resources and lending limits.

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There were also important policy innovations.[1] The first set came from the Fed, with its decision to extend its quantitative easing (QE) programme of asset purchases to include US investment-grade and 'fallen angel' corporate bonds. By compressing spreads on this asset class, this move had enormously positive spillover effects: first for US high-yield bonds, and soon after for emerging-market dollar-denominated bonds and eventually local-currency ones too. Through new 'repo' lines, the Fed offered foreign central banks the opportunity to obtain US dollars via repurchase agreements on securities issued by the US Treasury; this tool, though ultimately little used, helped relieve fears of massive liquidations of US Treasuries. Together, the above measures significantly alleviated investor risk aversion and fears of a dollar liquidity shortage. This helped to contain upward pressures on the dollar, and in turn eased global financial conditions.

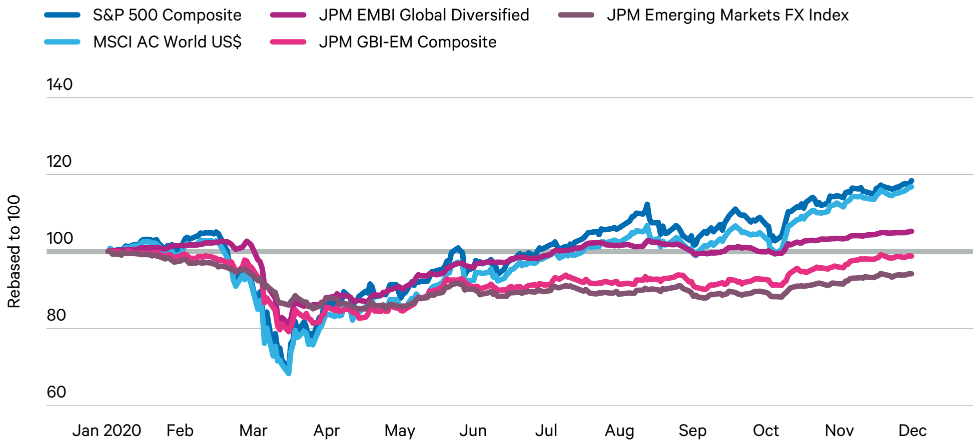
The second innovation in 2020 was that more than a dozen emerging-market central banks instituted domestic QE programmes of their own. This allowed the large increases in bond issuance from governments in those countries to be absorbed by markets without a large increase in borrowing costs, and hence without causing private sector borrowers to be crowded out. Remarkably, what many might regard as a worrying step towards 'fiscal dominance' – in which monetary policy becomes guided not by the inflation outlook but by the needs of fiscal policy, and which could herald a future jump in inflation – did not lead to meaningful currency depreciation.

1 Perhaps the most game-changing innovations took place in the realm of domestic liquidity, with central banks and fiscal authorities combining their financial firepower to extend liquidity and guarantees directly to the corporate sector. These measures, however, are beyond the scope of this paper.

The third innovation was the provision of liquidity to the poorest countries, in the form of temporary relief on debt service payments via the G20-sponsored DSSI. Under this initiative, 77 low-income countries were eligible for a postponement of debt service obligations falling due between May and December 2020. As of the G20 summit in November 2020, 46 countries had availed themselves of the opportunity to delay repayments to official creditors, accounting for $5.7 billion in relief. However, only one of the eligible countries had also requested debt service deferral from private sector creditors (this was, strictly, part of a broader negotiation rather than a DSSI-specific request). Fiscal monitoring by international organizations indicates that DSSI participant countries are undertaking substantial COVID-19-related spending even as they face major revenue shortfalls.[2]

Assessments of this set of policy responses during the first phase of the crisis have been overwhelmingly positive, the consensus being that the measures outlined above have contributed both to a 'V-shaped' global recovery in market prices and, to a lesser degree, to the more uneven and incomplete recovery in the real economy.

Figure 1. The 'V-shaped' recovery: selected index returns, 1 Jan–31 Dec 2020



Source: Refinitiv Datastream and BlackRock.

Looming challenges

If the early policy response to the pandemic has gone relatively smoothly in terms of averting a liquidity crisis, its next phase might pose more challenges. Most immediately, there is the question of **DSSI extension**. At their October 2020 meeting, G20 finance ministers and central bank governors moved to extend by six months, to the end of June 2021, the window for debt service relief under the DSSI, with the possibility of a further six-month extension after that. This decision was subsequently endorsed by G20 leaders at the November summit.

2 IMF and World Bank (2020), 'Joint IMF-WBG Staff Note: Implementation and Extension of the Debt Service Suspension Initiative', 16 October 2020, https://devcommittee.org/sites/dc/files/download/Documents/2020-10/Final%20DC2020-0007%20DSSI.pdf.

However, any liquidity problems that last for over a year are likely to morph into solvency problems, especially if full economic reopening is delayed by the slower distribution of vaccines expected in most emerging markets and developing countries. Indeed, this risk was explicitly acknowledged by the G20 leaders in their 2020 summit declaration: 'Given the scale of the COVID-19 crisis, the significant debt vulnerabilities and deteriorating outlook in many low-income countries, we recognize that debt treatments beyond the DSSI may be required on a case-by-case basis.'[3]

There is also growing political unease among policymakers and discontent from civil society at the lack of comparable debt service relief from private sector creditors, despite explicit expectations from the G20 that private creditors should provide appropriate assistance. The reason for this, however, is not foot-dragging by private creditors, who have consistently expressed their support for the DSSI and willingness to participate in the scheme, but rather a lack of requests from DSSI-eligible borrowers. This in turns comes from such countries' realization that by seeking even temporary debt service relief from private creditors, they will likely suffer credit rating downgrades and adversely impact their ability to access capital markets in the future – with negative implications for both the scale and cost of financing available to them. In other words, the borrowers themselves see more downsides than upsides to approaching private creditors for debt service suspension.

This situation is unlikely to change. Although some commentators interpreted Côte d'Ivoire's successful return to the capital markets in November, after previously receiving DSSI relief from official creditors, as validation that fears over market access were misplaced, it is in fact hard to draw such a conclusion. The key distinction is that such fears are associated with seeking DSSI relief from *private* creditors, which Côte d'Ivoire refrained from doing.

In some emerging markets and developing countries, though probably not many, issues of **debt sustainability** will need to be confronted. The growth shock caused by the pandemic has pushed a handful of countries with pre-existing debt problems into seeking debt restructuring: namely, at the time of writing, Angola, Argentina, Chad, Ecuador, Ethiopia, Lebanon and Zambia. Recession has also increased the number of countries in outright debt distress or at risk thereof. More than 50 per cent of low-income countries are now assessed to be at high risk of or in debt distress, according to the Joint IMF-World Bank Debt Sustainability Framework for Low-Income Countries.[4]

Private creditors are ready and willing to engage in debt restructurings, where required, to restore solvency in these countries. But there are other complications. In many of the debtor countries, there is less than full transparency regarding the amounts owed, the terms of the debt, and the identities of the creditors. In many, if not most, cases, China is a large creditor. But China is not a member of the so-called Paris Club of official creditors, which historically has played a key role

3 G20 Saudi Arabia 2020 Riyadh Summit (2020), 'Leaders' Declaration: G20 Riyadh Summit, November 21–22, 2020', https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/meetingdocument/wcms_761761.pdf.
4 IMF and World Bank Group (2020), *Joint IMF-WBG Staff Note: Implementation and Extension of the Debt Service Suspension Initiative*, 16 October 2020, https://www.devcommittee.org/sites/dc/files/download/Documents/2020-10/Final%20DC2020-0007%20DSSI.pdf.

in coordinating official-sector creditors in sovereign debt restructurings. In this context the creation of a Common Framework for Debt Treatments beyond the DSSI,[5] adopted by the G20 leaders at their November summit, is an important step forward, because it will facilitate having all the key creditors at the table.

What will remain will be the need for political consensus internationally on using this framework before solvency problems become too large, and with adequate safeguards to ensure that solvency is restored in a sustainable way. That another round of large-scale debt relief for the poorest countries is likely to be necessary 25 years after the launch of the Heavily Indebted Poor Countries (HIPC) Initiative suggests there are lessons still to be learned. In addition, the IMF has identified areas in which contractual debt provisions could be further strengthened to facilitate restructuring.[6]

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A more novel issue is the prospect of **monetary policy normalization**, in particular the timing and management of a future exit from QE in emerging markets. While enhanced policy cooperation between fiscal and monetary authorities in response to COVID-19 has been as beneficial in emerging markets as it has been in developed ones, the questions around how to unwind current extraordinary measures are likely to bite sooner and harder in emerging markets. As long as inflation is depressed and economies are operating well below full potential, it makes sense for governments and central banks to act in concert, as when central banks engage in QE by buying government debt on secondary bond markets. This allows governments to finance temporary spikes in their spending without triggering a rise in interest rates, which would tighten financial conditions for the entire economy and lead to even lower levels of activity and inflation.

However, as soon as inflationary pressures reappear, this unity of approach becomes harder to sustain. An independent central bank would need to remove some of its support to the economy even if the government concerned still wanted to issue more debt than the markets were prepared to finance. If the central bank failed to act pre-emptively, its inflation-fighting credibility could come into doubt, causing the local currency to depreciate and interest rates to rise anyway. If, on the other hand, the central bank did rein in its QE purchases while government debt issuance was still high, the interest rate required by the market would also go up.

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5 G20 Saudi Arabia 2020 Riyadh Summit (2020), 'Statement: Extraordinary G20 Finance Ministers and Central Bank Governors' Meeting, November 13, 2020 [Virtual]', https://www.imf.org/-/media/Files/News/news-articles/english-extraordinary-g20-fmcbg-statement-november-13.ashx.
6 IMF (2020), *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors–Recent Developments, Challenges, And Reform Options*, 1 October 2020, https://www.imf.org/en/Publications/Policy-Papers/Issues/2020/09/30/The-International-Architecture-for-Resolving-Sovereign-Debt-Involving-Private-Sector-49796.

Beyond domestically driven developments, interest rates on emerging-market debt will in any case also go up once interest rates start rising in developed markets. This, combined with much higher debt-to-GDP ratios post-COVID-19, could quickly create unsustainable debt dynamics. Even where fundamentals remain relatively sound, the mere change in sentiment could be damaging, with fears of a debt crisis potentially becoming self-fulfilling.

The US Fed's adoption of average inflation targeting – announced in August 2020[7] and likely to be emulated in less explicit fashion by other developed-market central banks – means we are probably a long way away from higher policy rates. This is because the regime shift will allow central banks to be more patient in the face of inflationary pressures before tightening policy.

That said, the timing of QE tapering is already a conversation topic among financial market actors and observers, and as long as growth is seen as healthy the Fed and its peers may not mind letting longer-dated bond yields rise. At the time of writing in late January, the US 10-year government bond was already yielding twice as much as it had at its 2020 trough. Thus, while the moment of reckoning for interest rates may not be just around the corner, it will come for sure. When this happens, countries that have not yet taken decisive steps to reduce their debt burdens may face a 'taper tantrum' event, with a sudden drying up of market liquidity leading to a sharp rise in their borrowing costs, potentially turning a hitherto sustainable debt into an unsustainable one. This could also happen sooner in countries where central banks that are struggling to escape fiscal dominance let inflation expectations get out of hand, triggering large-scale currency depreciation. While central banks in both developed and emerging markets are equally exposed to these risks in theory, in practice those in the latter are much more vulnerable, owing to less entrenched disinflationary pressures and weaker inflation-fighting credibility.

What more can be done?

Liquidity support

For outright liquidity provision, **large SDR allocations** could be considered. This tool was used very successfully in the wake of the 2008 global financial crisis without any significant adverse side effects. While there wasn't enough support from the IMF membership for such a move when it was first discussed in the spring of 2020, two factors could change the calculus: the absence of the hoped-for 'V-shaped' return to pre-pandemic normality in the real economy; and the change of political leadership in the US, which has veto power over decisions on SDR allocation. This means that as much as SDR 1 trillion ($1.4 trillion) could be allocated over the course of the next 14 months. Half of this amount could potentially be available any

7 Board of Governors of the Federal Reserve System (2020), 'Federal Open Market Committee announces approval of updates to its Statement on Longer-Run Goals and Monetary Policy Strategy', press release, 27 August 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200827a.htm.

time before the end of 2021, with a further SDR 500 billion available from the start of 2022 (the ceilings, and their phasing, are based on thresholds imposed by US legislation, below which SDR allocations do not require congressional approval).[8]

Each SDR 500 billion allocation would provide $21 billion of relief to DSSI-eligible countries without requiring costly or lengthy formalities, as well as over $150 billion to emerging markets and developing countries overall. Most countries in these groups are potentially vulnerable to sudden future liquidity droughts that would challenge their ability to finance themselves.[9]

The impact of these SDR allocations could be further increased by setting up a trust or facility to 'recycle' SDRs from countries with no need for them – notably, countries such as G7 members that are issuers of reserve currencies. Such a trust would need to be managed by a multilateral institution. Depending on the preferences of participating countries, the trust could either just on-lend the SDRs it receives to countries in need of liquidity, or use them as equity to back up market-based borrowing, thereby leveraging the original SDR allocation and amplifying its impact.[10]

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Any decision on implementation of an SDR allocation would rest squarely with the IMF and its Board of Governors. Unified impetus from the G7 should be sufficient to make at least the first proposed allocation happen. In 2009, it took less than five months from endorsement of the idea at the UK-hosted G20 summit in early April of that year for the allocation to take effect in late August.

Setting up a trust would arguably be more of a greenfield effort, though a template for such a mechanism exists. Moreover, unlike with SDR allocation, it would not depend on the support of a specific percentage of the IMF membership. Rather, it could proceed on the basis of a coalition of the willing among SDR recipient countries that do not intend to use their allocations. The World Bank or regional multilateral development banks (MDBs) would need to agree to manage the trust, but they could be expected to do so if a majority of their shareholders requested it.

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8 For a detailed discussion of the legal underpinnings and benefits, see Truman, E. M. (2020), 'The G20 missed an opportunity to expand financial resources for vulnerable countries', Peterson Institute for International Economics, 16 April 2020, https://www.piie.com/blogs/realtime-economic-issues-watch/g20-missed-opportunity-expand-financial-resources-vulnerable; and Collins, C. G. and Truman, E. M. (2020), 'IMF's special drawing rights to the rescue', Peterson Institute for International Economics, 10 April 2020, https://www.piie.com/blogs/realtime-economic-issues-watch/imfs-special-drawing-rights-rescue.
9 G30 Working Group on Sovereign Debt and COVID-19 (2020), *Sovereign Debt and Financing for Recovery after the COVID-19 Shock: Preliminary Report and Recommendations*, https://group30.org/publications/detail/4799.
10 For a more detailed discussion of this idea, see Bredenkamp, H. and Pattillo, C. (2010), *Financing the Response to Climate Change*, IMF, SPN 10/06, https://www.bookstore.imf.org/books/title/financing-the-response-to-climate-change.

Debt restructuring

At their November 2020 summit, G20 leaders endorsed a **common framework for sovereign debt restructuring**. The new framework commits all official creditors – including China, the largest non-Paris Club creditor – to taking part in debt restructurings requested by DSSI-eligible countries in the future. This constitutes a significant step forward. However, it will also be important to learn from past mistakes, drawing lessons from previous debt crises and their aftermath. The key requirements are likely to include:

- Early and constructive engagement with creditors (with a view to avoiding default).
- Credible, independent debt sustainability analysis.
- A robust policy framework extending many years into the future.
- A vision of how to meet sensible financing needs over the medium and long term. For the poorest countries, this will probably require greater recourse to grants or highly concessional loans – which donor countries and MDBs can offer cheaply given the global low interest rate environment. SDR allocations can help here too. For market-access countries, issuing sustainable bonds – possibly including a built-in adjustment mechanism such as GDP-linked payments – should be part of the solution.
- Stronger alert mechanisms to course-correct when countries appear to be back on a path towards debt distress.
- Investment in the creation of a comprehensive public repository of sovereign and publicly guaranteed debt, possibly tied to strong expectations in the new common framework that any debt not disclosed in the repository would be treated as a first-loss absorber.[11] The repository could rely on a combination of standard reporting tools, following the template for data on reserves developed by the IMF after the 1997–98 Asian financial crisis, and strong incentives, such as mandatory use of the template for any country applying for debt relief via the DSSI or for concessional lending from international financial institutions (IFIs). Over time, one would expect that markets, too, would reward countries willing to report their public debt transparently within the strictures of an agreed global standard. Compliance with such a standard could be audited on a periodic basis by the IFIs, with their conclusions made public.

The G7 and G20 could commission the IMF and World Bank to analyse the past 20 years of debt restructuring, going beyond mere assessments of process efficiency (as in the recently published review)[12] and focusing instead on understanding what is needed to make the return to solvency long-lasting. The G7 and G20 could then consider jointly committing to the recommendations emerging from this exercise. This should be done ahead of the upcoming IMF review, due in 2021, of its 'lending into arrears' policy, which is where a lot of the recommendations would need to be reflected.

11 For a similar proposal, see G30 Working Group on Sovereign Debt and COVID-19 (2020), *Sovereign Debt and Financing for Recovery after the COVID-19 Shock: Preliminary Report and Recommendations*.
12 IMF (2020), *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors–Recent Developments, Challenges, And Reform Options*.

Frameworks for policy normalization

The IMF could usefully develop **best practices or guidelines** to help emerging-market central banks and fiscal authorities normalize policy smoothly once the brunt of the COVID-19 economic shock has passed, and before market pressure forces them to act. A Flexible Credit Line (FCL) – a facility that offers countries with very strong fundamentals de facto unlimited access to IMF resources on a precautionary basis – could be offered to countries willing to commit to these guidelines. This would provide the authorities in participating countries both with an incentive to pursue sound policies and with the credibility to reassure markets that they will do so, thereby making it far less likely that the FCL would need to be drawn on. As is the case now, the IMF would have the option of declining to renew FCL access, when reviewed every six months, if the member country did not adhere to the guidelines.

Of course, in some countries the fundamentals may have deteriorated too much to permit FCL qualification. In these instances, conditionality-based IMF-supported programmes may prove necessary. Even then, committing large amounts on a precautionary basis may be a good way to smooth the transition from exceptional macroeconomic policies without creating unacceptable political stigma.

The IMF has ample lending capacity, having used up only about $150 billion of available funds of roughly $1 trillion; indeed, it has committed only $40 billion since the start of 2020.[13] However, it would be advisable for IMF member countries to review the adequacy of IMF resources on a more forward-looking basis should the aforementioned change in FCL use be approved. Member countries could also conceivably put in place new contingent resources, which could include the following: an increase in the New Arrangements to Borrow (NAB), which are standing collective borrowing agreements; or a new set of bilateral lending agreements that would be available as a back-up on an as-needed basis.

In the past, efforts to develop new IMF precautionary facilities giving countries access to large resources relative to their IMF quotas have been hampered by fundamental differences between, on the one hand, the views of potential borrowers as to which features make such facilities appealing and, on the other, the concerns of a subset of creditor countries anxious to avoid moral hazard and open-ended commitments. The creation in April 2020 of the ill-fated Short-term Liquidity Line is the latest illustration of these difficulties. It might therefore be advisable for the G7 to convene a working group with officials from large emerging markets to explore whether common ground can be found on a blueprint for enhanced precautionary facilities, the details of which the IMF could then elaborate.

13 See the latest and historic data at IMF (undated), 'IMF Credit Outstanding for all members from January 01, 2020 to December 31, 2020', https://www.imf.org/external/np/fin/tad/extcred4.aspx?date1key=2021-01-31&category=EXC&reportdate=2020-12-31. For a breakdown of the different sources of finance available, see IMF (2020), 'Where the IMF Gets Its Money', 31 March 2020, https://www.imf.org/en/About/Factsheets/Where-the-IMF-Gets-Its-Money. While some may argue that $1 trillion is not much compared to global capital flows, IMF resources have in fact kept pace with the sizeable increase in such flows in the wake of the global financial crisis, and by most metrics are above their long-term average. See, for example, the analysis provided in European Central Bank (2018), *A quantitative analysis of the size of IMF resources*, Occasional Paper Series, No. 213, October 2018, https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op213.en.pdf.

Emerging-market capital market development

There is growing investor appetite globally for **impact investing**, which emphasizes the environmental and social benefits of investments as well as their financial returns. Where macroeconomic fundamentals are healthy, there is likely to be substantial demand for green and social bonds issued by emerging markets and developing countries, both in hard and local currencies.

However, the market for impact investing is still nascent. Liquidity is limited. This alone is a significant deterrent for many investors, who would otherwise welcome both the higher yields offered by emerging-market debt and the potentially positive contribution of impact investment to meeting the UN's Sustainable Development Goals. In addition, perceived and historical risks remain too large for many investors to stomach. Conversely, many potential issuers fear having to pay a liquidity premium for issuing sustainable bonds; as a result, only a few have done so to date in emerging markets despite the abundance of projects that would qualify for this type of financing, particularly in a post-COVID-19 era in which the 'build back better' mantra will come to the fore. Collective action can help on several fronts:

1. Jumpstarting emerging-market sustainable bond issuance

— A simultaneous commitment by G20 members to finance a significant part of their funding needs in coming years through sustainable bonds would help to jumpstart the market, and would remove stigma about the returns associated with such instruments.

— In turn, the existence of a widely diversified market would increase the appeal of this nascent asset class to global investors.

— A broadly accepted framework already exists for defining a sustainable bond, which typically consists of a green bond, a social bond or a combination of both. The framework was developed by the International Capital Market Association (ICMA),[14] and was used recently by Mexico for a very successful issuance.[15] G7 and G20 members could usefully endorse this framework and commit to abide by it in their own issuance of sustainable bonds. This would considerably reduce the risk of 'green-washing', and limit the idiosyncratic due diligence requirements for each new issuance that currently hold back a number of potential investors.

Once issuance starts occurring at scale, liquidity concerns should diminish and demand for sustainable bonds should become entrenched, possibly even exceeding supply – as is now often the case for green bonds in developed markets, where a 'greenium' thus applies. Investor appetite will be also helped by increasing recognition that exposure to sustainable assets can make portfolios more resilient. Moreover, research suggests that climate change may over time make traditional

14 International Capital Market Association (undated), 'The Principles', https://www.icmagroup.org/sustainable-finance/the-principles.
15 United Nations Development Programme (2020), 'Historic $890 million Sustainable Development Goals Bond issued by Mexico', 14 September 2020, https://www.undp.org/content/undp/en/home/news-centre/news/2020/Historic_890_million_SDG_Bond_issued_by_Mexico.html.

forms of emerging-market debt less attractive for global investors because of its greater exposure to adverse impacts.[16] Emerging-market sovereigns may see in the issuance of sustainable bonds a way to counter this development.

2. Exploring new ways to deploy official development assistance (ODA) and leverage MDB balance sheets

MDBs could be tasked by their shareholders to develop a menu of options, consistent with their respective mandates and institutional constraints, to use their balance sheets in a way that directly supports capital market development in emerging markets and developing countries, but with an emphasis on local-currency markets rather than on primarily lending directly to sovereigns and corporates. For example, the following approaches could be considered:

- **De-risking of bonds and loans issued by sovereigns or corporates in emerging markets and developing countries.** Securitization of loans would allow risk diversification. And bonds could be de-risked if tranching was implemented, with MDBs or bilateral lenders taking on the first-loss tranche.
- **Credit enhancements in the form of guarantees if contingency features in bond contracts are activated.** Although debt service relief linked to GDP shocks, commodity price shocks or natural disasters is theoretically attractive, in practice such provisions are seldom used because investors have a hard time pricing them. Moreover, by erring on the side of caution, investors tend to make the pricing of bonds including such provisions unattractive for issuers. However, this problem would be ameliorated if losses were taken at least in part by MDBs rather than entirely by bondholders when the trigger event arises. Having an independent official authority verify the circumstances of the trigger event would be useful in this respect. Guarantees could also help governments and their creditors reach common ground in some restructuring cases.

The climate finance track of discussions around COP26,[17] scheduled for November 2021, should offer an opportunity to generate momentum for scaled-up allocations of ODA by the G7 and others. Deploying some of these funds in a way that encourages and supports access to private finance, along the lines discussed above, would maximize their impact.

Conclusion

While international liquidity *per se* has not, as yet, proved to be a lasting source of concern during the pandemic-induced economic shock that started in 2020, there will undoubtedly be after-effects to deal with. These could be mitigated with further liquidity-related policy innovations behind which the G7 and G20 could usefully throw their support.

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16 BlackRock Investment Institute (2021), *Climate change – Turning investment risk into opportunity: Launching our climate-aware capital market assumptions and strategic portfolios*, February 2021, https://www.blackrock.com/corporate/literature/whitepaper/bii-portfolio-perspectives-february-2021.pdf.
17 26th Conference of the Parties to the United Nations Framework Convention on Climate Change.

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The author contributed this policy brief in her personal capacity. The views expressed here may not be construed to represent those of BlackRock, nor of Bruegel.

About this series

This briefing paper is part of a series being published by Chatham House's Global Economy and Finance Programme under the project 'Rebuilding International Economic Cooperation'. The recent election of Joe Biden as US president raises the prospect of a renewed push to find multilateral solutions to global economic problems, coordinated by the G7 and G20 in 2021 and beyond. But the mechanisms of the past won't simply snap back into place. The extent of common ground needs to be established; trust needs to be rebuilt; and technical solutions to problems found.

This project seeks to support that process by putting forward practical, collaborative, politically viable solutions to some of the economic challenges the world currently faces. The papers are authored by independent economic policy experts from the private sector, academia and think-tanks, often with a public policy background. Each paper addresses a specific problem, made more acute by the COVID-19 pandemic, where international economic cooperation can make a significant difference.

For further details, please see https://www.chathamhouse.org/about-us/our-departments/global-economy-and-finance-programme/rebuilding-international-economic-cooperation.

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