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A Proposal for the IMF: A New Instrument of International Liquidity Provision for Emerging Markets and Developing Economies

CLAAF: Latin America Committee on Macroeconomic and Financial Issues

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Abstract

This paper addresses a critical flaw in the international financial system: the failure to address the inherent asymmetry between countries that issue reserve currencies and those that do not, leaving the latter vulnerable during systemic liquidity crises. We propose an IMF-managed Emerging Market Fund (EMF) to confront these crises in emerging markets and developing economies. The EMF would be able to make temporary purchases of sovereign debt in secondary markets when financial contagion is not justified by economic fundamentals. Unlike typical IMF tools, the EMF focuses on stabilizing bond markets rather than providing country-specific loans. The EMF would independently determine when and how to intervene, as well as which basket or index of countries would be subject to intervention. Crucially, countries would not need to request activation, avoiding the stigma of seeking IMF support. At the end of the paper, we answer "Frequently Asked Questions" to clarify key elements of the proposal.

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The problem[1]

Accidents can happen in imperfect international financial markets. Systemic *liquidity* crises affecting emerging and developing economies (EMDEs) are often a case in point.[2] They are typically driven by a combination of uncertainty, collective action failures (problems of coordination, free riding, and uninternalized externalities), and collective cognition failures (for instance, wild swings in investors' moods from exuberance to panic). These could greatly widen the wedge between social and private interests, and between perception and reality, thereby brewing socially inefficient financial dynamics that markets, left to their own devices, cannot adequately address.

A sudden systemic dry up of liquidity—i.e., a sudden contraction or stop in flows of international credit through financial intermediaries or capital markets—typically involving fire sales and downward price spirals, can easily spread across markets and borders and turn into a major financial crisis that obliterates the balance sheets of otherwise solvent economies. These events normally result in severe economic collapses and in an unnecessary amount of pain in the population.

It is important to stress that counting with what ex-ante appears to be a sound macroeconomic policy framework may not prevent countries from being strongly affected by systemic crises. Good policies certainly may reduce the probability of being affected by financial contagion but, in the case of EMDEs, they do not provide foolproof protection.

Advanced economies can mitigate the unwarranted effects of systemic liquidity crises through their lender-of-last-resort facilities (whether existing ones or those especially designed for the occasion) *because* they enjoy the ability to issue hard currencies; namely, highly liquid currencies—or more generally liquid transactional assets—that are widely traded around the world.[3] Moreover, when the epicenter of the crises has been in the advanced economies, G7 countries have been willing to extend liquidity assistance to some "systemically important" countries. For instance, the US Federal Reserve (Fed) has relied on swap lines with other major central banks to mitigate the severity and duration of episodes of financial turmoil and, above all, avoid disruption in the US Treasuries market. In the European context, institutions such as the European Stability Mechanism (ESM) and the European Central Bank (ECB)'s Transmission Protection Instrument created in 2022 have also contributed effectively to significantly reduce financial contagion. These initiatives have produced indirect benefits even to emerging economies not involved in such schemes since they are aimed at preventing severe contractions in global liquidity.

1 The Committee benefitted from comments and suggestions received by participants in private roundtables on areas of reform for the IMF, organized by CGD, ARIF (Advocates for the Reform of International Finance) and the G-24, and by discussions during a workshop at the International Monetary Fund in early 2024.

2 There is an ample literature characterizing systemic liquidity crises and their implications for economic policy; see Calvo (2016).

3 In particular, the US Dollar is often referred to as the *dominant currency* because a large proportion of international trade and finance is denominated or conducted in that currency.

The situation is very different, however, when the epicenter of a contagious financial crisis is in EMDEs. Their inability to issue reserve currencies severely limits their capacity to respond effectively to a flight from their financial liabilities denominated in foreign currency.[4] Lacking access to the insurance services of a true international lender-of-last-resort, EMDEs are compelled to self-protect by relying on the hard currency issued by the advanced economies. They do so mainly by accumulating expensive international reserves. Some EMDEs, in addition, try to bolster their self-protection by securing contingent liquidity lines from the IMF or swap lines from advanced economies' central banks.[5] But these are far from efficient solutions.

Experience shows that, faced with a systemic liquidity crisis that spills over markets and borders, international reserves may not only be insufficient to protect the individual country that owns them but also, more importantly, that they do little or nothing to limit the unwarranted spread of contagion towards otherwise fundamentally sound countries. Experience also shows that these problems are not adequately addressed by the current IMF liquidity facilities. This is not just because EMDEs prefer not to seek access to such facilities as ex-ante insurance for times of turmoil to avoid adverse signaling—the so-called "stigma" effect. It is also, and more fundamentally so, because they are designed for individual countries, that is, mainly with an idiosyncratic rather than a systemic view.[6]

The current international financial architecture thus fails to address the dire implications of the basic asymmetry between countries that issue reserve currencies and countries that do not and do not normally have access to swap lines provided by G-7 central banks. As a result, the market failures that are behind socially inefficient systemic liquidity crises also remain unaddressed as regards EMDEs. This is the void that the EMF proposed in this statement is meant to fill.

4 Often a run from foreign-currency denominated liabilities is followed by a run from financial liabilities issued in domestic currency and international reserves are used to support the exchange rate in order to avoid a sudden and steep depreciation.

5 Fed swap lines were offered to Brazil and Mexico during the global financial crisis and during the COVID pandemic. Also, in March 2020, the FED established the Foreign and International Monetary Authorities (FIMA) Repo Facility (overnight repos) which provides access to US dollars in exchange for central banks' holdings of US Treasury bonds; the latter, however, is a very short-term facility and depends on countries' holdings of US treasuries which need to be used as collateral for accessing US dollars. For a detailed description, see https://www.cgdev.org/blog/primer-fed-and-imfs-emergency-tools-emerging-markets#:~:text=Swap%20lines%20have%20played%20a,swap%20line%20with%20the%20Fed.

6 The fact that all IMF liquidity facilities must be requested and activated by the member country is at the heart of the Emerging Markets Fund (EMF) proposal put forward by the Committee in its Statement #46.

A proposal: An IMF-managed Emerging Markets Fund (EMF)[7]

In its Statement 46 (June 2023), the Committee argues that the IMF can reduce the asymmetry that emerges from EMDEs inability to issue reserve currencies by managing an EMF that performs the functions of an international lender of last resort, enhancing the liquidity of emerging markets' sovereign external debt when international capital market disruptions hit their economies.

Motivated by the ECB's Transmission Protection Instrument the Committee has proposed setting up an EMF aimed at reducing the contagion that may be triggered by turbulence in international capital markets. In a systemic event, the EMF's role would be "to counter disorderly market dynamics that are not warranted by emerging markets' fundamentals". *It is important to recognize at the outset that identifying the start of a systemic event is by no means an easy task. The EMF's determination that a systemic liquidity crisis has started requires profound analysis and is certainly one of the EMF's central operational decisions. Engaging in the details of such determination exceeds the scope of this document. Our objective here is to discuss the basic principles of the Committee's recent proposal while identifying some important EMF operational challenges for further definition by the EMF itself.*

Counting with appropriate funding (to be discussed below), the EMF would be authorized to make temporary secondary market purchases of sovereign debt of a group of emerging markets countries where there is evidence of financial contagion effects unwarranted by fundamentals. Since each systemic crisis has its own, unique characteristics, the EMF should have the flexibility to decide on the group of countries that justify its intervention. Depending on the crisis dynamics, the EMF could decide to constrain its intervention to a limited number of countries or, alternatively, to a larger number of countries. In the latter case, the EMF might find it appropriate to conduct transactions in terms of an emerging markets' bond index such as the EMBIGD (Emerging Market Bond Global Diversified Index) or, if considered necessary, in terms of an index specifically constructed by the EMF for its intervention purposes.

By creating an instrument that prevents systemic crises, the EMF would contribute to the financial stability of all EMDEs, not just those emerging markets with greater access to the international capital markets. Namely, by preventing financial contagion the EMF's intervention would benefit even countries whose bonds are not directly traded by the EMF. The reason is that the EMF intervention is aimed at reducing EM market risk—what sometimes is referred to as *Beta* risk in financial jargon. A reduction in market risk translates into a principal component of country risk of all EMDEs, independently of the idiosyncratic component of risk—often referred to as *Alpha* risk—associated with each country's fundamentals: quality of policies and institutional strength.

7 Our EMF proposal builds upon the original scheme along these lines advanced by Guillermo Calvo; see, Calvo, G. (2002).

The proposed mechanism is seen by the Committee as an instrument that "completes" the IMF toolkit for dealing with the contagion effects of sharp declines in global liquidity. In particular, while all existing IMF facilities have focused on "quantities" (i.e., the provision of dollars on a country-by country basis) the key feature of the EMF is that it focuses directly on "prices" during a liquidity squeeze (i.e., the increase in the cost of external funding as reflected by increases in bonds' yields and spreads of the emerging market asset class). The EMF proposal tackles the price issue directly.

Moreover, by design, the proposed EMF instrument is not subject to the problems of existing facilities as outlined above:

- It is automatic: countries do not have to ask for its activation. Thus, there are no "stigma problems" as with the IMF contingent credit line facilities; instruments that have been reviewed by the IMF Board several times but have had no real success in attracting takers.
- It is ready to be used when needed since the set-up of this instrument requires that appropriate funding is already in place (see below). Therefore, there is no need for additional and protracted negotiations as, for example, in the case of SDR allocations.
- It does not depend on the willingness of central banks from advanced economies to offer discretionary swap lines, as in the case of the Fed's swaps offered to Brazil and Mexico during the global financial crisis and the COVID crisis.
- It has a systemic perspective and approach. Instead of providing liquidity support to individual countries, it seeks to address the socially unwarranted costs of liquidity stress on fundamentally solvent emerging economies.
- A flexible but rule-based EMF also contributes to reducing political pressures and debates that are sometimes present in decisions for IMF lending.

However, the Committee recognizes the EMF proposal must respond to a seemingly unsurmountable criticism: What is the point of having a fund to protect emerging countries with good fundamentals from systemic liquidity crises, when in the two most representative and serious systemic crisis episodes of the 21st century—the global financial crisis and the COVID-19 epidemic—neither resulted in an interruption of international financing to emerging countries? Why is it necessary to create an instrument to solve a problem that no longer exists? Are we not trying to fight the *last war*, in particular, the one that originated in the wake of Russia's default in August 1998?

The Committee believes that the fundamental reason the global financial crisis did not result in a disruption of financing flows to emerging countries is that the financial crisis originated in the US and spread throughout the developed world. This led the Central Banks of countries capable of issuing reserve currency—such as the Fed or the ECB—to inject liquidity very aggressively to prevent the financial crisis from resulting in a global liquidity crunch. Although the liquidity expansion was not done with the emerging markets in mind, they did benefit from the expansionary policies that the Fed and other major central banks deployed to protect their financial systems, not to protect the

health of emerging markets. In other words, in this crisis the emerging countries had an indirect lender of last resort in hard currency.

Something similar happened during the COVID-19 crisis. Although the health crisis did not originate in advanced countries, it had a severe impact regardless of development status. The COVID-19 crisis led central banks from advanced economies to issue reserve currency to inject liquidity very aggressively—in fact, much more aggressively than during the 2008–09 global financial crisis. Once again, emerging countries benefited indirectly from this global liquidity injection that was not necessarily aimed at protecting their own financial health.

But what would happen if the crisis broke out in an emerging country—as happened in the case of Russia's default in 1998—and spread to other emerging countries which, despite exhibiting solid fundamentals, suddenly saw international financing cut off? If the epicenter of the crisis were not in the developed countries or did not affect the developed countries, would central banks from advanced economies be willing to provide liquidity to the international bond market of emerging countries? The short answer is probably not.

The heart of the matter is precisely that, since the global financial crisis and the COVID-19 pandemic, debt levels have risen in emerging countries—as they have in advanced countries—leaving the international emerging bond market accident-prone and without an institutional mechanism to provide liquidity to a global market of more than 30 trillion dollars. It is for this key reason that the Committee believes a proposal such as the EMF, called to repair a market failure, is long overdue.

There are two features of the EMF that deserve special attention: its funding and its ability to avoid moral hazard problems. These will be discussed next.

Funding the EMF

Ensuring adequate funding for the EMF is central to its success. The credibility of the EMF as an effective instrument to contain systemic financial contagion lies in securing access to sufficient funds to avoid speculative attacks against the emerging market bonds whose prices it is attempting to stabilize.

The Committee envisions two alternatives to achieve this goal.[8] In the first alternative, the EMF could be managed by the IMF but segregated from its balance sheet, under *clear but flexible rules of intervention and decision-making*, and with an *independent board* prepared to act on short notice during periods of systemic stress. The trigger of EMF interventions involves the critical judgement call that EMDEs are experiencing a systemic financial contagion event and, therefore, the EMF requires strong governance. In this case, the EMF funding could be engineered by the advanced economies' central banks that issue reserve currency by pre-committing swap lines with the EMF,

8 Originally, the Committee advanced only the first alternative. Valuable comments and discussions led the Committee to add a second alternative for consideration.

thus avoiding the unnecessary pain imposed on EMDEs during times of international capital market disruptions. In this context, EMF funding could emerge as a mechanism to facilitate coordination among major central banks over the response to systemic crises that, as happened in the past, may disrupt the normal functioning of mature bond markets.[9]

As a second alternative, the EMF could be managed within the IMF's balance sheet, as part of its institutional toolkit. The benefit of this alternative is that no separate institutional arrangement would need to be in place, particularly since EMF's interventions should be expected to be sporadic and triggered by infrequent events of systemic crises affecting EMDEs. Moreover, as a new instrument to prevent systemic crises is put in place, such events may become even more isolated.

Both alternatives face significant challenges. In the case where the EMF operates segregated from the IMF's balance sheet, the central challenge is how to secure adequate funding from advanced economies' central banks, especially since the decision to intervene in EMDEs bond markets would need to be made by an independent EMF.

In the second alternative, the major challenge is whether the IMF could commit a certain amount of its unused lending capacity to ensure appropriate funding for the EMF. While currently the outstanding IMF commitments amount to less than 30 percent of its lending capacity, unanticipated future developments in the global economy may require a significant increase in IMF traditional lending.[10] Very relevant to this discussion is certainly the approval by the IMF Board of Governors in December 2023 of an increase of members quota by 50 percent, which will maintain the institution's current lending capacity, as current bilateral borrowing agreements expire.[11]

A piece of good news is that, although this figure may change over time, the Committee's calculations, based on previous crisis episodes, indicate that adequately funding the EMF would require about USD 300 billion, equivalent to the outstanding stock of emerging market sovereign short-term international bond debt (approximately equal to 20 percent of the outstanding stock of total *emerging market sovereign international bond debt*). This amount, relatively modest in the context of advanced economies interventions in financial markets, eases the constraints faced by either of the two alternatives.

Dealing with moral hazard: The timing of EMF intervention

The Committee recognizes that the creation of the EMF would introduce a trade-off between the benefit of preventing systemic financial contagion by providing liquidity and the cost of the moral hazard distortion that results from providing a put option that induces creditors to incur excessive

9 For instance, the fall of LTCM in 1998 can be attributed to the effects that emerging market crises had on the behavior of the US Treasury market.

10 According to IMF's data (as September 27, 2024), the IMF's total resources under the General Resources Account (GRA) amounted to USD 977 billion while total IMF credit outstanding stood at USD 120.6 billion and undrawn commitments at USD 100 billion; see https://www.imf.org/external/np/tre/activity/2024/092724.pdf.

11 See IMF Press Release 23/459, December 15, 2023.

risk-taking in emerging market assets. This tradeoff is complex, because the forward-looking nature of capital markets implies that the put option may induce foreign investors to take larger emerging market positions than otherwise would during normal times when markets are calm. This, in turn, would induce general overpricing of emerging market assets.

To mitigate these put-option effects, EMF's interventions must be made contingent on metrics indicating that the probability of systemic financial contagion is high and possibly rising. Interventions must be specifically triggered by an EMF's management decision. As discussed at the outset, identifying that a systemic event is underway is inherently complex, yet necessary for a timely triggering of an EMF intervention. Once triggered, furthermore, the EMF would face the challenge of avoiding purchasing bonds of countries with clearly unviable fiscal and balance-of-payments trajectories that are therefore in need of debt restructuring rather than of emergency liquidity support (a thorny tension between Type I versus Type II errors). Hence, the EMF should count on highly trained and expert staff on systemic financial fragility and liquidity issues. In this respect, the Committee believes that, by carrying out its member countries' surveillance and having access to an unparalleled amount of relevant data, the IMF is uniquely positioned to *develop tools directed at monitoring factors that may lead to systemic crises' building*. Such efforts could significantly enhance the ex-ante, preventive/prudential role that the IMF can play in global finance. And the EMF would itself buttress the IMF's role in ex-post crises management and resolution.

Because triggering EMF interventions is a complex decision, EMF management should be empowered with flexibility. However, in this context, it is highly desirable that EMF interventions, while flexible, be rule-based, both in their deployments as well as in their unwinding once the systemic event ends. The fact that EMF interventions are temporary and would be triggered once a decision has been reached that a systemic event is unfolding would help ensure that the benefit of preventing impending systemic crises outweighs the put-option distortions. Moreover, the Committee believes that systemic interventions may be less subject to moral hazard and political pressures than in country-specific liquidity assistance lines.

The unwinding of EMF's interventions after a systemic event is deemed to have ceased is also a difficult decision and may be subject to moral-hazard considerations similar to those associated with the start of interventions. The unwinding process may take different forms at different times and be conditional on the assets held by the EMF. In this context, similarly to the existing discussion over the Fed's quantitative tightening in the US, the EMF's unwinding process may involve, for instance, outright asset sales following a transparently communicated program or it may involve simply letting bonds mature passively, or a combination of both strategies.

Finally, keeping the EMF inactive at times when the probability of systemic financial crises is low would significantly weaken the put-option distortions. Since the EMF should not intervene in cases of solvency problems, it would need to be vigilant to recognize situations where overall liquidity problems reflect fundamental insolvency across the emerging market asset class.

Frequently Asked Questions

An important aspect of the proposal is that there are many operational issues that will need to be addressed by the board and staff of the EMF once it is established. The Committee acknowledges that, as the proposal is currently at the conceptual stage, it cannot and should not provide specific details on how the EMF will function. Nevertheless, important conceptual questions have been raised during discussions with key stakeholders. Below are the Committee's responses to these questions.

- **What is the market failure that the EMF tries to correct?**

Several market failures can be addressed by the Emerging Market Fund (EMF). Uncertainty alone is arguably sufficient to justify the EMF. However, other market failures add complexities that bolster the case for the EMF.

Consider first a minimalist setting where uncertainty coexists with the inability of emerging market countries (EMs) to issue reserve currencies. Uncertainty, an important ingredient in virtually all systemic crises, leads to incomplete markets for many contingencies and requires market players to adapt to unpredictable changes through sequential contracting. Under these conditions, an unexpected, low-probability but high-cost exogenous shock can drastically boost risk aversion and widen bid-ask spreads, suddenly drying up market liquidity and precipitating a fire sale of dollar-denominated EM bonds. Leverage would amplify the resulting credit crunch and associated economic losses for EMs. EMs cannot feasibly self-protect or insure against all bad states of the world, nor can they issue dollars (the "refuge" currency) when a massive run away from EM bonds and to liquidity occurs. A risk-neutral EMF would fill the void. It would serve the public interest by curbing excessive downward spirals, mitigating the costs of the credit crunch, and easing the recovery of the EM bond market to normalcy. Moreover, by its existence, the EMF would influence market expectations thus reducing the probability of systemic liquidity crises.

As other market imperfections are added, the grounds to justify the EMF only strengthen. Consider principal-agent frictions, namely, asymmetric information and enforcement costs. To address them, market players rely on monitoring and collateral. But in turbulent financial times, punctuated by high uncertainty and risk aversion, the market fails to align the incentives of the agents (asset managers, debtors) with those of the principals (ultimate investors in the fund, creditors), as the cost of monitoring rises sharply and its effectiveness vanishes compared to the alternative of simply selling off EM bonds across the board. Moreover, rules and constraints regarding pledgeable collateral may exacerbate margin calls, greatly amplifying fire sales. A risk-neutral EMF makes even more sense in these circumstances, given the greater need to dampen socially costly market dynamics in the EM bond market.

Adding collective actions frictions—namely, uninternalized externalities, coordination costs, and free riding—complicates matters significantly by widening the wedge between

private and social interests. Investors in the EM bond market are likely to lend more than what is socially prudent because they do not internalize the negative externalities to the system of EM excess debt leading to eventual fire sales. Moreover, under a run to liquidity, pecuniary externalities (downward price spillovers) interact with collateral constraints to further boost risk aversion, fire sales, and contagion. [12] In addition, coordination frictions open the scope for rational yet self-fulfilling runs—that is, runs that can render insolvent an EM that would otherwise remain viable. As players in the EM bond market do not adequately factor in the social costs of their individual actions, their behavior during a liquidity crisis leads to amplified financial gyrations that can greatly augment the severity of the losses to the international financial system and innocent bystanders. The market failures stemming from collective action frictions thus substantially raise the social value of last-resort liquidity provision by the EMF, which would not only help reduce unnecessary costs if a crisis occurs but would also help prevent the materialization of destructive self-fulfilling runs.

Finally, adding cognition frictions (bounded rationality, behavioral economy-type biases) to the mix further solidifies the policy rationale in favor of the EMF. Cognition frictions can unleash the type of moody herding behavior that underpins the phenomena of irrational exuberance and uncontrolled panic in financial markets. Caught up in non-rational collective mood swings, momentum traders can end up dominating and destabilizing the EM bond market, with collateral constraints and coordination problems undermining the ability of rational arbitrageurs to counteract such financial tsunamis. A risk-neutral EMF has under these circumstances an additional, socially beneficial role to play—it can help organize collective action to temper wild mood swings and eliminate bad equilibria.

Any or a combination of the above market imperfections can suddenly and excessively dry up liquidity in the EM bond market. However, singling out with precision the underlying causes (i.e., the combination of market failures) behind a socially harmful illiquidity crisis does not need to be part of the mandate of the EMF. Instead, what is essential for the EMF to operate well is to be guided by carefully designed criteria and rules of engagement to ensure that it can (i) adequately identify the symptoms of a systemic liquidity crisis that would trigger its interventions; and (ii) avoid interventions that could cause excessive distortions overall.

- **The EMF interventions aim at stabilizing bond *markets* rather than the economic conditions of specific countries, correct?**

Correct. The goal is to avoid sharp disruptions in EM's bond markets during times of extreme financial turbulence, which can trigger contagion across the emerging markets asset class. EMF interventions aim to mitigate contagion by reducing overall market-liquidity risk for emerging market bonds to prevent unnecessarily painful liquidity crunches. This crucial characteristic

12 Further discussion on the role of these externalities during periods of systemic global crises can be found in Bianchi and Mendoza (2020) and Bianchi and Lorenzoni (2022).

distinguishes the EMF from the existing IMF tools for liquidity provision, such as the Flexible Credit Line, which are granted on a country-by-country basis.

This means that the EMF would need to intervene in a basket of EM bonds or in an EM bond index, either in an existing one, such as the EMBIGD (which is currently composed of a large number of countries), or in an ETF, such as the EMB, or in one specifically designed by the EMF to address in the most efficient way the particular characteristics of the crisis whose effects it is trying to alleviate. It is important to stress that, in any alternative, the definition of an index determines an intervention rule that is predicated on a market concept as opposed to a country-specific action.

- **Why should the EMF only intervene in foreign currency bonds and not bonds issued in domestic currency?**

The EMF is proposed as an instrument to overcome the fact that emerging market economies are unable to issue hard currencies. Hence, the primary objective of the EMF is to help preventing systemic capital market disruptions that result in a sudden loss of credibility in terms of the government's ability to service its hard-currency debt.

Although there are important factors that emerge in dealing with disruptions in the domestic public debt market—addressed in CLAAF statement 46—servicing the domestic debt is always within a government's possibility as it issues domestic currency. Hence, the Committee views the management of domestic debt (e.g., size, maturity structure, and dynamics) as primarily a matter of domestic policy and prudential regulation.

- **How can moral hazard effects be mitigated?**

As stated in the proposal, the Committee recognizes that EMF interventions during crises may create moral hazard by offering a put option, incentivizing investors to take excessive risks in emerging market assets during stable periods. This issue, however, is not unique to the EMF. During the most recent financial crises, central banks in advanced economies faced similar challenges when they provided emergency liquidity to certain markets or asset classes in fulfillment of their financial stability mandate. For instance, the term "Fed put" reflects the perception that the U.S. Federal Reserve will provide liquidity during severe financial distress.

Nonetheless, such potentially undesirable side effects did not undermine the justification for the Fed's (and other major central banks') emergency liquidity policies, as these interventions mitigated social costs and significantly benefited the functioning of the economy. Instead, emergency liquidity policies highlighted the need for moral hazard-offsetting policies.

Following the example of the US Fed and other major central banks in advanced economies, the EMF governance and rules of engagement should be designed to enhance the effectiveness of its emergency liquidity interventions while mitigating moral hazard. A crucial guiding principle in this regard is that EMF interventions should be rare, occurring only when there is a clear indication of a systemic liquidity crisis. Also, when determining the scope and timing of its interventions, the EMF should strive to ascertain that the benefits from its actions outweigh potential undesirable side effects.

Moreover, the potential moral hazard side effects of the EMF argue for complementing it with (i) careful and systematic monitoring of the financial viability of emerging markets—a task for which the IMF is eminently suited, and (ii) an effective, officially sanctioned sovereign debt restructuring framework.

- **What should be the EMF retrenchment strategy?**

One important question is how to make interventions in markets temporary. That is, if during a period of systemic stress in financial markets, the EMF acquired sovereign bonds issued by EMs, how would the fund dispose of that paper once the extraordinary circumstances passed?

This is the same conundrum that central banks from advanced economies have faced when engaging in non-conventional monetary policies. First comes the period of Quantitative Easing (QE), when central banks issue reserves to purchase bonds, followed by the period of Quantitative Tightening (QT), when the monetary authority reduces its holdings of bonds, whether by repurchasing or by letting them reach maturity.

Given the similarity between the two situations, rather than designing a whole new system, we propose to borrow from the experience of advanced economies' central banks and the lessons that have emerged. Central banks have engaged in two kinds of QT: active QT, where the central bank announces a calendar for the sale of its bond holdings, specifying the amounts to be sold at each date; and passive QT, in which the bonds held in the central bank portfolios are simply amortized at maturity, when the bondholding effectively expires.

Which strategy is preferred, or which mixture of the two strategies is optimal, will depend on the maturity of the paper held, the speed with which authorities want to carry out the tightening, and the liquidity conditions in the relevant markets. Thus, a significant degree of judgment will need to be exercised depending on the specific market circumstances.

We propose that the EMF adopts analogous criteria and learns from the experiences of central banks in advanced economies, which are unfolding at the time of writing.

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