In Hangzhou in September 2016, G20 Leaders endorsed the “G20 Agenda Towards A More Stable and Resilient International Financial Architecture”. Beyond the G20 Summit in Hangzhou, G20 Finance Ministers and Central Bank Governors decided to extend the IFA Working Group into 2017, in order to follow up on the work done in 2016 in some areas and complete it in others.

Against that backdrop, the International Financial Architecture Working Group was maintained by the German presidency. Some of the issues related to the multilateral development banks which were previously dealt with within the Investment and Infrastructure Working Group (IIWG) were also included in the IFA agenda.

The first WG meeting was held in Berlin on December 2nd, 2016. Members of the Working Group agreed on the terms of reference of the group (see Annex 1), aiming at further strengthening the international financial architecture by (i) progressing the work undertaken in 2016 to improve the analysis and monitoring of capital flows and management of risks stemming from excessive capital flow volatility, (ii) developing the ongoing work to further strengthen the Global Financial Safety Net (GFSN), with a strong, quota-based and adequately resourced IMF at its center, (iii) advancing the work on improving debt sustainability and debt restructuring processes, (iv) continuing optimizing MDBs balance sheets and mobilizing resources from private sources, and enhance cooperation among multilateral lenders.

Ahead of the second IFA Working Group meeting, an OECD workshop on the OECD Code of Liberalization of Capital Movements was organized on February 15th, 2017 in Paris to promote informal and open discussions, in order to inform and provide clarifications on the Code’s issues.

The second IFA Working Group meeting was then organized in Paris, on February 16th, 2017. Ahead of the meeting, the WG co-chairs circulated a list of possible deliverables and timelines for the Working Group, so as to narrow the scope of work on concrete and precise items to work on this year. Draft documents of possible deliverables which will be proposed to G20 Deputies and consequently, possibly, to G20 Finance Ministers and Central Bank Governors for endorsement at their meeting in Baden-Baden in March were also shared and discussed during this meeting.

Finally, acknowledgements should be given to the contributions of international organizations, which have been, as usual, key components of the WG task (see the list of IOs contributions in Annex 2).

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The discussions in the IFA WG have focused on four main areas so far:

1/ Progress the work undertaken in 2016 to improve the analysis and monitoring of capital flows and management of risks stemming from excessive capital flow volatility

Members of the WG agreed on the importance to improve the early detection and management of vulnerabilities notably stemming from large and volatile cross-border flows. They also agreed on the need for improving related procedures through sharing of country experiences in handling capital flows, as well as for enhancing data collection to reduce remaining gaps. Members discussed in particular the indicators that should be monitored so as to improve risk assessment. Members noted
that there were some areas that could benefit from further work and clarification, particularly exploring the relationship between capital flow and macroprudential measures, analysis on the effectiveness of capital flow measures and the role of source countries.

Members of the WG also discussed the issue of consistency between the IMF’s Institutional View and the OECD Code of Liberalisation of Capital Movements regarding the management of capital flows. Some members called for enhanced consistency in the two documents in order to properly address increased volatility of capital flows in international financial market, while others considered that the two have different purposes and do not show inconsistencies. Some members asked for enhanced flexibility of the Code given globalized and interconnected financial markets, especially regarding prudential measures for financial stability and noted that enhanced flexibility would facilitate wider adherence from emerging countries to the Code. Other members stressed on the contrary the need to preserve the high standards of the OECD Code. Eventually, some members underlined that the key issue was the transition period, and how to manage flexibility in the short term while ensuring convergence in the middle to long term. Some non-OECD G20 members expressed the willingness to move towards adherence to the OECD Code. Others indicated being open to discuss and progress on the issue, but held reservations regarding their own adherence to the Code. Members welcomed being kept informed of the ongoing work on the review of the OECD Code, including work on its flexibility. The OECD will issue a progress report on OECD Code related matters by the G20 Finance Ministers and Central Bank Governors meeting in March.

2/ Develop the ongoing work to further strengthen the Global Financial Safety Net (GFSN), with a strong, quota-based and adequately resourced IMF at its center

Members of the WG supported the ongoing work to further strengthen the Global Financial Safety Net (GFSN), with a strong, quota-based and adequately resourced IMF at its center. They agreed that the IFA WG should regularly take stock of ongoing discussions in the IMF and review progress. There was a broad consensus to support the efforts by the IMF to further enhance the effectiveness of its lending toolkit in line with its mandate, including on a possible new liquidity support instrument as well as a new policy support instrument. Members of the WG remained committed to working expeditiously according to the agreed work agenda and timeline of the IMF towards the conclusion of the 15th General Review of Quotas, to be completed no later than the 2019 Annual Meetings. They also recognized the importance of adequate GFSN for low and middle income countries, including in Sub-Saharan Africa.

Some members reaffirmed that any realignment under the 15th review in quota shares was expected to result in increased shares for dynamic economies in line with their relative positions in the world economy, and hence likely in the share of emerging market and developing countries as a whole. It was also reminded that the WBG should implement its shareholding review according to the agreed roadmap and timeframe, with the objective of achieving equitable voting power over time.

Members of the WG also discussed the first results of the IMF-Chiang Mai Initiative Multilateralization joint test run and explored ways to further enhance effective cooperation between the IMF and regional financing arrangements, respecting their mandates.

3/ Advance the work on improving debt sustainability and debt restructuring processes

Members of the WG underlined the importance of implementing and promoting sound and sustainable financing practices and continuing to improve debt restructuring processes. To this end, they agreed on the “G20 Operational Guidelines for Sustainable Financing” (see Annex 3) that will be
proposed to G20 Deputies and consequently, possibly, to G20 Finance Ministers and Central Bank Governors for endorsement at their meeting in Baden-Baden in March 2017. These Guidelines aim at providing an operational implementation framework to the general elements that are set out in the Addis Ababa Action Agenda.

As asked in the Hangzhou Communique, the IMF provided further analysis of state-contingent debt instruments (SCDIs). Members of the WG welcomed the work by the IMF. Focusing on GDP-linked bonds as one particular SCDI, they discussed the possible design, challenges and benefits of the use of such an instrument by types of issuers. They agreed on a “Compass for GDP-linked bonds” (see Annex 4) summarizing this discussion, that will be proposed to G20 Deputies and consequently, possibly, to G20 Finance Ministers and Central Bank Governors for endorsement at their meeting in Baden-Baden in March 2017.

Members of the WG also agreed to follow up on the state of implementation of the incorporation of the enhanced collective action and pari passu clauses into the new issuances of international sovereign bonds. They supported the continuation of this effort, as well as further reflections on the issues surrounding the outstanding stock of debt that do not contain the enhanced clauses.

4/ Continue optimizing MDBs balance sheets and mobilizing resources from private sources, and enhance cooperation among multilateral lenders

Members of the WG reaffirmed the importance of promoting investment in terms of both quantity and quality. They stressed the role of Multilateral Development Banks (MDBs) in advancing the development agenda and providing and catalyzing investment.

Members of the WG discussed ways to more effectively mobilize private resources to finance investment. They welcomed the work presented by MDBs on first steps towards Principles and Ambitions on Crowding-in Private Finance. They asked MDBs to present an update to FMCBG in March and deepen and finalize the principles for endorsement at the FMCBGs’ meeting in April. Members also called on MDBs to re-enforce their work on the ambitions and present a first draft for discussion at IFA WG #3 in April, incorporating the standard methodology to measure private capital mobilization and laying out avenues on how to increase such mobilization.

They also agreed that the IFA WG should continue engagement with the MDBs with regard to (i) the “Multilateral Development Banks Action Plan to Optimize Balance Sheets”, (ii) the “MDBs Joint Declaration of Aspirations on Actions to Support Infrastructure Investment” and (iii) the launch of the Global Infrastructure Connectivity Alliance. They asked for an update on their state of implementation through MDBs and MDBs’ reports by the G20 Leaders’ Summit in Hamburg.

The IMF and the MDBs presented to the WG the state of play of the coordination between IFIs, when countries are requiring financial assistance while experiencing macroeconomic vulnerabilities. Members of the WG agreed on the “G-20 Principles for effective coordination between the IMF and MDBs in case of countries requesting financing while facing macroeconomic vulnerabilities” (see Annex 5), which will help ensure a coherent approach and coordinated response between the IMF and MDBs in such circumstances. These Principles will be proposed to G20 Deputies and consequently, possibly, to G20 Finance Ministers and Central Bank Governors for endorsement at their meeting in Baden-Baden in March 2017.
In addition to the abovementioned issues, members of the WG agreed to continue to discuss ongoing initiatives to strengthen local currency bond markets, the broader use of the SDR, and the progress of IMF quota review at upcoming meetings of the WG on the basis of available IMF or other IOs’ documents.
Annex 1:

G20 International Financial Architecture Working Group

2017 Work program and timetable

1. Background

In Hangzhou in September 2016, G20 Leaders endorsed the G20 Agenda towards a More Stable and Resilient International Financial Architecture. There was also an agreement to continue the work of the International Financial Architecture Working Group (IFA WG) under the German G20 Presidency. The German Presidency will put specific emphasis on the overarching concept of “economic resilience”, to which the work of the IFA WG can make important contributions. The IFA WG will also include in 2017 elements of the ongoing work related to the multilateral and regional development banks which were previously dealt with in the Investment and Infrastructure Working Group (IIWG), that has now been closed.

2. Work program for 2017

To ensure efficient and results-oriented discussions, the IFA WG will focus on a limited number of priority areas and potential deliverables during 2017, taking into account the emphasis put on the objective of enhancing economic resilience. The work will be concentrated on the following four areas:

1/ Progress the work undertaken in 2016 to improve the analysis and monitoring of capital flows and management of risks stemming from excessive capital flow volatility.

The IFA WG will follow-upon the recommendations made in 2016 to:

➢ Improve the analysis and monitoring of capital flows and risks.

This refers to the ongoing work, anchored in the G20 IFA Agenda agreed in Hangzhou, on closing the data gaps; more regular thorough discussions among G20 FMCBG on emerging risks related to capital flows, global liquidity, spillover and spillback effects, building on existing work and on the IMF Surveillance Note; sharing of experience of national and multilateral early warning systems and frameworks, including their methodology, on a voluntary basis; implementation of the commitment by G20 members to undergo Article IV Consultations annually and FSAPs each five years, and to publish the results of the staff consultations; and encouraging all countries to participate in COFER.

➢ Learn from country experiences to enhance policy responses to cope with capital flow volatility.

Furthermore, the IFA WG will examine and discuss the findings of the IMF’s review of experiences with the “institutional view” adopted in 2012. It will also discuss and review the ongoing efforts on bringing together the work from IOs on capital flows management and macroprudential policies. And it will provide an opportunity for the OECD to update G20 members on the ongoing review of the OECD Code of Liberalisation of Capital Movements and for G20 members to exchange on the possible adherence by interested G20 members to the OECD Capital Code.

2/ Develop the ongoing work to further strengthen the Global Financial Safety Net (GFSN), with a strong, quota-based and adequately resourced IMF at its center.
IOs have been asked in 2016 to deliver on a number of elements in 2017. The WG will focus on regularly taking stock of, and discussing, the progress made by IOs in their respective areas of work while building on the achievements to further advance the work on strengthening the GFSN.

- **Further enhance the effectiveness of the IMF’s lending tools to serve its global membership.**

IMF members have agreed to expeditiously work towards finalizing the ongoing review of the IMF’s lending toolkit to further enhance its effectiveness, and they have reaffirmed their commitment to a strong, quota-based, and adequately resourced IMF, to fulfill its global role. As a first key step, the IMF plans to work on IMF facilities between October 2016 and mid-2017. Following this, in Q3 of 2017, the IMF Board will turn its attention to the completion of the 15th General Review of Quotas (GRQ), according to the agreed IMF timetable. The IFA WG will work towards forging a consensus on, and finalizing the review of, the IMF lending toolkit in line with this timetable.

- **Promote the interaction between the IMF and RFAs.**

Together with the IMF, the IFA WG will review and discuss progress made on the cooperation between IMF and RFAs, and identify feasible IMF-RFA partnership tasks, such as supporting the RFA capacity building. According to the IMF’s work plan work on this topic will be carried out between October 2016 and mid-2017, including on the joint test runs, notably the lessons learnt from the CMIM IMF joint test run conducted in 2016.

### 3/ Advance the work on improving debt sustainability and debt restructuring processes.

The IFA WG will focus its work in 2017 on:

- **Promoting sound and sustainable financing practices.**

The G20 underlined in 2016 the risks posed by a possible buildup of sovereign debt in some countries, notably low-income countries, against the backdrop of a sharp drop in commodity prices and tightening in financial conditions, and called for monitoring these risks. Building on the Addis Ababa Action Agenda, the G20 also decided to further discuss ways to promote sound and sustainable financing practices including through inclusive discussions with low-income countries. A key progress in this area, and an important task for the IFA WG in 2017, could be to produce **Operational Guidelines for Sustainable Financing**, aimed at providing an operational implementation framework to the general elements that are set out in the Addis Ababa Action Agenda. The G20 called also on the WB and IMF to explore further options on technical assistance, and there will be scope for the IFA WG to review these options in 2017.

- **Exploring state contingent financial instruments to enhance sustainability and stability.**

In 2016, the IFA WG initiated a discussion on innovative forms of sovereign borrowing, in particular state-contingent debt instruments such as GDP-linked bonds. Members of the IFA WG were in favor of investigating further the pros and cons of state-contingent debt instruments, including exploring the operational viability of GDP-linked bonds. The IFA WG will take stock of the work undertaken by the IMF and contributions from interested countries on these issues and consider the pros and cons of state-contingent financial instruments, in particular GDP-linked bonds, and possible ways forward.

- **Continue incorporating enhanced collective action and pari passu clauses into sovereign bonds.**
The IFA WG will follow up on the state of implementation of the incorporation of the enhanced collective action and *pari passu* clauses into the new issuances of sovereign bonds. It will also discuss the IMF’s continued exploration of ways to resolve the issues surrounding the outstanding stock of debt that do not contain the enhanced clauses. And it will examine and discuss additional measures taken by some jurisdictions to smooth the sovereign debt restructuring processes.

4/ Continue optimizing MDBs balance sheets and mobilizing resources from private sources, and enhance cooperation among multilateral lenders

- **Optimize MDBs balance sheets and mobilize resources from private sources**

Building on work done in the G20 IIGWG, optimizing MDBs balance sheet and mobilising resources from private sources to foster investment, especially in infrastructure, in client countries are key priorities. The IFA WG will further advance the work on implementing the “G20 Action Plan for MDB Balance Sheets Optimization” and will follow-up on the Global Investment Connectivity Initiative, as well as “MDBs Joint declaration of aspirations on actions to support infrastructure investment”, and with due respect to the different governance structures of each institution. The IFA WG will also engage with MDB’s to reach a Joint declaration of MDB aspirations for crowding-in private sector investment.

- **Further enhance cooperation among multilateral lenders**

The IFA WG will discuss ways to further enhance cooperation and coordination among multilateral lenders, particularly with respect to crises response, especially the IMF, the World Bank and regional development banks (RDBs), consistent with their respective mandates, with a view to ensuring a coherent approach.

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In addition to the abovementioned issues, the IFA WG will provide an opportunity to advance G20 discussion and consensus on issues whose time horizons go beyond the Hamburg Summit, including the development of local currency bond markets; broader use of the SDR; and the subsequent steps to achieve the completion of the IMF’s 15th General Review of Quotas, including a new quota formula, by 2019. Discussions on those issues will be put on the agenda of IFA WG meetings according to the expected timetable of availability of the necessary background documents.

Members of the IFA WG are also reminded that, as agreed in Hangzhou, G20 Leaders “support the World Bank Group to implement its shareholding review according to the agreed roadmap, timeframe and principles, with the objective of achieving equitable voting power over time”.

3. Working Arrangements

As in 2016, the IFA WG will work in close coordination with the Presidency to contribute to the preparation of the relevant sessions in G20 Deputies and G20 Finance Ministers and Central Bank Governors’ meetings, and integrate guidance from these meetings, as well as the relevant outcomes of expert conferences (e.g. on “enhancing resilience” and digitalization) into its work stream. The IFA WG will continue to be co-chaired by Korea and France. Each G20 member will identify two principal and two alternate representatives from the Finance Ministries and Central Banks. Countries invited by the Presidency will nominate one representative and one alternate. As in 2016, the IMF, the World Bank, the OECD, the BIS and the FSB will be invited to all meetings and are expected to provide expertise on relevant issues. Regional development banks will be invited to the relevant
sessions. The co-chairs may invite other relevant international organizations as well as independent technical experts when needed.

The IFA WG will hold face-to-face meetings as well as conference calls and exchange of documents through emails in the execution of its work.

The IFA WG will inform Ministers and Governors about the progress in the work streams at their March meeting. An interim report will be prepared for the April meeting, while the final report will be sent to Ministers and Governors for their meeting prior to the Hamburg summit 2017.

The co-chairs will provide the secretarial support for the IFA WG. The timing, venue and agenda of the meetings will be determined by the co-chairs in coordination with the Presidency.

4. Timetable (tentative)

Four physical meetings are envisaged:

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<th>Date</th>
<th>Event</th>
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<tr>
<td>1-2 December</td>
<td>G20 Deputies meeting + 1st IFA WG meeting in Berlin</td>
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<tr>
<td>16 February</td>
<td>2nd IFA WG meeting in Paris</td>
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<td>15-18 March</td>
<td>G20 Deputies and G20 FMCBG meeting in Baden-Baden</td>
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<tr>
<td>19-23 April</td>
<td>Spring meetings; G20 FMCBG meeting + 3rd IFA WG meeting in Washington D.C.</td>
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<td>2 - 3 June</td>
<td>4th IFA WG meeting in Korea, preceded by a workshop on Capital Flows and Early Warning Systems</td>
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<td>7-8 July</td>
<td>G20 Summit in Hamburg</td>
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Annex 2:

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<tr>
<th>International Financial Architecture Working Group</th>
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<tbody>
<tr>
<td><strong>List of documents produced by the international organizations and multilateral development banks</strong></td>
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- IMF, “Staff Note for the G20 on State-contingent Debt Instruments for Sovereigns”, February 2017
- Inter-Agency Group on Economic and Financial Statistics (IAG), “Update the on the Data Gaps Initiative and the Outcome of the Workshop on Data Sharing”, March 2017
Annex 3:

G20 Operational Guidelines for Sustainable Financing

Draft (March 2017)

The Addis Ababa Action Agenda on Financing for Development recognizes that “borrowing is an important tool for financing investment critical to achieving sustainable development, including the sustainable development goals. Sovereign borrowing also allows government finance to play a countercyclical role over economic cycles. However, borrowing needs to be managed prudently”. In this regard, UN member states “reiterate[d] that debtors and creditors must work together to prevent and resolve unsustainable debt situations”, that “maintaining sustainable debt levels is the responsibility of the borrowing countries; however […] acknowledge[d] that lenders also have a responsibility to lend in a way that does not undermine a country’s debt sustainability”, and agreed to “work towards a global consensus on guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, building on existing initiatives.”

Against this backdrop, G20 countries endorse and will promote the following operational guidelines, taking into account national circumstances. The aim of these guidelines is to enhance access to sound financing for development while ensuring that sovereign debt remains on a sustainable path by fostering information-sharing and cooperation among borrowers, creditors and international financial institutions, as well as learning through capacity building.

These operational guidelines are classified into five dimensions: adequacy, transparency, consistency, coordination and resilience.

1. **Adequate financing for sustainable development**

   - **Exploration of options to provide adequate financing for developing countries.** Sovereign debtors and creditors will work together to strike a right balance between meeting financial needs for investment and sustainable development and maintaining debt sustainability. They will continue to explore various financing options to help developing countries access long-term financing and bolstering potential growth, while preserving sustainable debt levels.

2. **Information-sharing and transparency**

   - **Promotion of transparency regarding macroeconomic indicators and debt sustainability assessments.** Sovereign creditors and debtors should build a common understanding of the macroeconomic and financial situation of the borrower country, based on the most recent estimates of the international financial institutions (IFIs), including the latest Debt Sustainability Analysis (DSA). In this regard, G20 countries will enhance information sharing with respect to debt sustainability, including signaling to IFIs’ staff if large public liabilities appear not to have been included in the DSA of a debtor country. Moreover, they encourage borrowing countries to continue to enhance fiscal transparency and public debt management, as well as to provide the IMF, and other IFIs as appropriate, information on their debt and indirect liabilities (e.g. as guarantors of public entities).

   - **Promotion of transparency regarding relevant cases of past sovereign debt restructurings.** As a general policy, information on past debt restructurings from official and private creditors should be made public, as appropriate.

3. **Consistency of financial support**

   - **Consistency of borrowing and lending practices with debt limit policies as a shared responsibility of debtors and creditors.** As emphasized in the Addis Ababa Action Agenda, borrowing countries and lenders, including sovereign lenders, share responsibilities in maintaining debt on a sustainable path. G20 countries recognize the applicable requirements of the IMF’s Debt Limit Policy (DLP) and of the International Development Association’s Non-Concessional Borrowing Policy (NCBP), and commit, as shareholders of those institutions, to improving the transparency in providing financing to debtor countries and working closely with the IFIs to help debtor countries meet those debt sustainability
requirements. In order to achieve that, IFIs need to have early consultation with and if necessary alert creditors on borrowing countries' debt levels to avoid any potential inconsistency. Debt ceilings and most recently reported borrowing levels are being collected in one table which is public and regularly updated by the IFIs, helping in providing information to all lenders and borrowers about possible opportunities and constraints.

- **Committing to the long-term debt sustainability of borrowing countries**, notably by aiming at ensuring that commercial creditors adequately contribute to debt relief when required, and by ensuring that official creditors deliver on their own commitments. When unavoidable, debt restructuring should be conducted in good faith in a timely, orderly, and effective manner, facilitating appropriate burden-sharing.

- **Provision of the necessary technical assistance to debtor countries**, directly or through the international institutions in order to enhance their debt management capacities, while ensuring recipient countries take ownership over building their debt management capacities. This specifically covers the ability to staff and train debt management offices, and to ensure their familiarity with the different forms of sovereign borrowing, as well as the costs and opportunities attached to them. G20 countries support the Debt Management Facility (DMF) of the IMF and the World Bank and the Debt Management and Financial Analysis System (DMFAS) program of the United Nations Conference on Trade and Development (UNCTAD), and the ongoing work aimed at strengthening the Debt Sustainability Framework (DSF) of the IMF and the World Bank as a shared reference by all potential lenders in their dealings with a borrower.

4. **Coordination of stakeholders**

- **Ensuring a regular dialogue between sovereign creditors, debtors and international financial institutions.** Interaction on a regular basis between these stakeholders, and not only at times of distress, is the most efficient way of fostering trust among sovereign actors. This will consequently make it easier for crises to be identified and anticipated, and for their resolution to be implemented. The IMF, the Paris Forum and Paris Club meetings, and UNCTAD are examples of venues where such a dialogue can take place.

- **Ensuring coordinated policies between international financial institutions.** Interaction and policy coordination on a regular basis between the IMF, the World Bank, the regional development banks, and other financial and development institutions will promote more efficient development, budgetary and other loan policies and ensure a consistent approach for safeguarding financial sustainability.

5. **Promotion of contractual and new financial instruments and minimizing litigation issues to strengthen resilience**

- **Continue to work on and consider usage of new financial instruments, when relevant, that embed more resilience into the debt structure of the recipient country**, for instance GDP-indexed contracts, debt instruments with extendible maturities, and natural disaster mechanisms, targeted to limit patterns of repeated over-indebtedness in the most vulnerable countries. G20 countries encourage the development of local currency bond markets as a way of improving the resilience of the domestic economy and financial system.

- **Promotion of enhanced contractual clauses most often found in foreign-law sovereign bond issuances (modified *pari passu* and enhanced collective action clauses – CACs).** International sovereign bonds are an increasingly prevalent form of external indebtedness for countries. G20 countries commit to continue promoting the standards best suited to avoid protracted negotiations with minority holders.

- **Address the challenges posed by some litigating creditors.** Aggressive litigation by non-cooperative minority creditors poses challenges in the financing and debt restructuring processes, especially for the poorest countries that lack the technical capacity to face such a legal challenge. G20 countries commit to explore enhanced international monitoring of litigation by non-cooperative minority creditors and take action as appropriate.
This document summarizes recent considerations with regard to state-contingent debt instruments and focuses more specifically on GDP-linked bonds. Based on the IMF’s “Staff Note for the G20: State-Contingent Debt Instruments for Sovereigns” it presents a systematic, yet not exhaustive, overview of important aspects of GDP-linked bonds listing benefits, challenges and their potential mitigating factors, as well as considerations on instrument design. Its objective is to inform interested sovereigns and investors that aim at navigating the territory of GDP-linked bonds.

(1) Why we address the subject of GDP-linked bonds
At our meeting in Chengdu in July 2016, we called for further analysis of the technicalities, opportunities and challenges of state contingent debt instruments including GDP-linked bonds. Sovereign state-contingent debt instruments are not new. There is already a long history across many countries of the use of inflation-linked bonds. At the same time it is important to ensure the lessons experienced with GDP-linked warrants are fully taken on board. With this document we aim at:

- **Examining solutions that may contribute to fiscal flexibility and debt sustainability.** From a conceptual perspective, well-defined GDP-linked bonds are promising instruments as they may offer additional opportunities of risk-sharing among sovereigns and private investors thus having the potential to contribute to debt sustainability.

- **Unlocking potential by addressing pros and cons.** So far, practical experiences with GDP-linked instruments have been limited. Before potential advantages of GDP-linked bonds can be unlocked we deem it necessary to provide a systematic view on possible benefits and challenges as well as mitigating factors.

- **Formulating an initial reference for interested sovereigns.** This compass aims to add value to the current discourse on GDP-linked bonds by combining conceptual considerations and insights of market participants that may inform and serve as a first reference for interested sovereigns when assessing whether to issue GDP-linked bonds and how to design such instruments. Prospective issuers who want to explore this new market segment may want to rely on these references also with a view to possibly coordinate issuances.

(2) Potential benefits to sovereigns and the international financial system
We view GDP-linked bonds as potentially beneficial instruments when designed in ways which may:

- **Generate policy space in difficult economic times.** GDP-linked bonds can tie a country’s debt service to its ability to pay thus reducing public debt service in difficult economic times and generating space for counter-cyclical policy. Therefore, GDP-linked bonds may not only provide risk-diversification benefits for sovereigns but also for international investors and strengthen the global financial system when facing economic shocks.

- **Facilitate counter-cyclical policy.** This feature could be particularly useful to sovereigns looking to complement existing macro policy tools.

- **Offer ancillary benefits** such as widening the set of financial instruments, contributing to enhancing the completeness of financial markets.

(3) **Challenges and mitigating factors**

The use of GDP-linked bonds faces a number of challenges. Whether they can add benefits to issuers and the international financial system will crucially depend on how potential challenges can be mitigated. Specifically, challenges include how GDP-linked bonds adjust to GDP fluctuations, the specification of the state variable, the adjustment mechanism, their price, their investor base, their novelty or liquidity premia during the transition period, their share in public debt of the respective country and design issues as well as the availability of reliable data for measuring GDP development. For these instruments to be effective and economical we believe that, among other things, it would be important to

- **Take steps to reduce costs of insurance.** The costs of insurance will depend on how GDP-linked bonds and their markets are instituted:
  - Benchmarking / standardizing the design of GDP-linked bonds by choosing a straightforward architecture can reduce liquidity, novelty and complexity premia.
  - Including floors in the design of GDP-linked bonds may limit the variance of investor income flows from these instruments and reduce premia. Such floors would need to be designed carefully if the insurance benefits of the instruments are to be sufficiently preserved.
  - Issuance of GDP-linked bonds by several interested sovereigns may benefit market development by overcoming problems of adverse selection, helping deepen markets and reduce new issuance premia.
  - As GDP-linked bonds can contribute to debt sustainability of a country, their benefits could translate into lower risk premia for conventional debt, too.
• **Carefully assess the demand.** Further consultations with debt managers and market participants would be needed; in particular, the potential interest of international investors for this financial tool should be carefully scrutinized.

• **Target international investors.** Diversifying the investor base for GDP-linked bonds would spread the income effect of a country-specific economic shock and could assist with countercyclical demand smoothing.

• **Fulfill statistical, technical and regulatory prerequisites.** Reliable and timely statistics are essential for the functioning of GDP-linked bond-markets. A sound regulatory framework needs to be in place to alleviate potential risks of a migration of budgetary risk into parts of the financial system ill-suited to bear it and will also address the perception of moral hazard associated with the political difficulty of sharing the upside of growth with investors.

(4) **Key choices on the design of GDP-linked bonds**

GDP-linked bonds can be designed in multiple ways to accommodate country-specific circumstances. The design of possible variants requires a careful analysis of the complex technicalities associated with the specific features of each type of bonds.

• **Fixed-income or equity-like products:** GDP-linked bonds can be designed as fixed-income products where coupon payments vary with economic performance, or as equity-like products where principal repayments (possibly in addition to coupon) vary with (cumulative) GDP growth. Issuers may choose either design depending on their preferences, albeit at the cost of less standardization.

• **Choice of state variable:** Some investors and sovereigns may prefer real rather than nominal GDP (when linking to level or cumulative growth). For diversified economies, nominal GDP would be a natural choice of state variable due to the close correlation with their tax bases. For commodity dependent countries, there may be greater benefits from linking to the relevant commodity price, which has the advantage of being readily and more immediately verifiable.

• **Foreign or local currency instruments:** Local currency GDP-linked bonds offer the greatest benefits and may be particularly suitable for well-diversified economies with access already to local currency bond markets. GDP-linked FX-instruments deliver smaller benefits (due to FX risks) but may be more suitable for countries that lack well-developed local currency debt markets, and need particularly to target international investors.

• **Maturity-extending mechanisms:** Other types of GDP-linked bonds are sovereign convertible bonds with fixed principal and coupon payments which include a provision of extending maturity by a specified amount of time, e.g.
related to weak GDP development. If appropriately designed, they could be issued with the objective of preventing the flight of investors during crises.
Annex 5:

G20 Principles for effective coordination between the IMF and MDBs in case of countries requesting financing while facing macroeconomic vulnerabilities

*Draft March 2017*

Multilateral development banks (MDBs) frequently play an important role in helping to address countries’ financing requirements during periods of macroeconomic vulnerability. For this type of MDB financing to be most effective, it should build on the implementation of sound policy frameworks, and countries’ engagement with the IMF, which is the lead institution to assess macroeconomic conditions and advise countries on the appropriate actions to restore macroeconomic stability. Insufficient coordination between the IMF and MDBs may undermine macroeconomic adjustments, with negative impacts on a country’s economic growth and stability.

In order to enhance the decision-making process, the IMF and the MDBs should be encouraged to ensure effective coordination when MDBs consider providing financing to countries facing macroeconomic vulnerabilities and more broadly when programmatic policy-based lending is envisaged.

In the end, it should however be clear that each institution should remain responsible for its lending decisions and be independent in reaching them.

Against this background, and building on existing good practices, the G20 has devised the following Principles for effective coordination between the IMF and MDBs in case of countries requesting financing while facing macroeconomic vulnerabilities.

1. **The MDBs should:**
   
   - Engage in a regular dialogue with the IMF to proactively identify potential opportunities for coordination and to ensure consistent policy signaling.
   - When considering a budget-support loan, provide their Boards of Directors with convincing evidence, based on a recent IMF assessment, that a country has in place a sound macroeconomic policy framework.
   - Offer emergency financing to help a country address macroeconomic vulnerabilities only after having received an assessment by the IMF that an appropriate macroeconomic framework is in place and appropriate actions are being taken to restore macroeconomic stability or there is a credible commitment to adopting and implementing such policies. This assessment should be provided to MDB Boards of Directors for their consideration and with the view to inform their decision, as a complement to MDB staffs’ own assessment.
   - Encourage countries experiencing BoP crisis to pursue an IMF-supported program (funded or unfunded) in order to establish a credible and consistent policy framework for restoring macroeconomic stability.
   - Structure lending in a manner to provide the borrowing country with appropriate incentives to carry through with its program of reform commitments, including, for example, through sequenced disbursements and corresponding conditions that are consistent with IMF conditionality. Substantive prior actions, grounded in areas in which the MDB has appropriate expertise, should be in place before resources are disbursed.
• Ensure, where appropriate, that the lending underpins a government’s commitment to pro-poor social programs and well-targeted social safety nets to the extent that the country’s macroeconomic adjustment places poor and vulnerable segments of the population at risk.
• Accurately categorize the type of support required (e.g., countercyclical, balance of payment, programmatic) to appropriately structure the terms of the budget support loans (e.g., tenor, grace period, conditionality).

2. **The IMF should:**

• Upon request from an MDB that it is considering providing financing to help a country address macroeconomic vulnerabilities, provide a clear, frank, and up to date assessment of the country’s macroeconomic situation and prospects, and of macroeconomic and related structural policies. Such an assessment could be provided through i) an IMF Executive Board assessment in a recent Article IV consultation or program review, or ii) when conditions have changed or the most recent assessment is more than 6 months old, an assessment letter that contains a clear and candid assessment of a) the member’s macroeconomic conditions and prospects and b) current macroeconomic and related structural policies.
• Maintain open lines of communication and provide the MDBs with updates on the IMF’s assessment of macroeconomic conditions and policies ahead of any additional MDB Board decisions on provision of financial support or subsequent loan tranches, and engage in a constant dialogue and exchange with the MDBs on the subject.

3. **The IMF and the MDBs should:**

• Ensure close communication between their respective staff teams working on countries experiencing, or likely to experience, macroeconomic vulnerabilities.
• Establish, as appropriate, channels for “upstream” exchanges of views between senior managers of the respective institutions on possible provision of MDB financial support to countries facing macroeconomic instability (for instance, development of lines of inter-agency communication at an appropriately senior level regarding macroeconomic assessments; establishment of structured exchanges of views on country cases during the Spring and Annual Meetings of the IMF-WB; etc.).
• Enhance coordination around provision of technical assistance and capacity building, especially for low-income countries, in order to reinforce their capacity to anticipate, analyze and respond to a crisis.
• Conduct a regular evaluation, by the Board of Directors of the institutions, of the implementation of these guidelines.