

AN INTERNATIONAL FINANCIAL ARCHITECTURE FOR STABILITY AND DEVELOPMENT

Strengthening the Global Financial Safety Net

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Abstract

The purpose of the Global Financial Safety Net (GFSN) is to secure financial stability by preventing crisis contagion and providing support for the countries in crisis. Now we are approaching the 10th year anniversary of Lehman Brothers failure and the onset of the global financial (and maybe - structural) crisis, which raised the issue of broader international interactions in building the Global Financial Safety Net to prevent deep and full-scaled financial crisis in single countries or regional economic systems. The old-fashioned system of Bretton-Woods institutions led by the IMF with all its many elements still suffer from serious shortcomings. Hence, the G20 together with all international financial institutions should continue their efforts aimed at strengthening the system in the coming years.

Challenge

Since the first submit in 2008, G20 leaders have repeatedly committed to reform international monetary governance, to mitigate financial risks and to secure global financial stability. Such decision reflects that G20 countries are fully aware of the fact that national policies are domestic but their consequences are global. However, concrete steps for close policy coordination among G20 are still absent.

We have seen that capital flows can be volatile and unpredictable. They are subject to powerful push factors, such as unconventional monetary policies by the central banks of the major economies, not just the domestic policies in the affected countries. Therefore, in case we want to succeed in encouraging the financial openness and liberalization of capital flows, more needs to be done to reassure the authorities in emerging market and smaller advanced economies in adequate safeguards against potentially harmful and costly financial instability.

At the national level, such safeguards include foreign exchange reserves accumulated by domestic central banks, as well as, to a certain extent, some foreign assets in the sovereign wealth funds. The GFSN now includes all types of foreign financing, but the sources of such financing are very diverse. During the global financial crisis, key central banks, including the FED, the ECB, the Bank of England, and the Bank of Japan, had provided multiple bilateral swap arrangements. There is also a large network of swaps established by China and other countries. Also, we have recently seen a rapid growth of regional financing arrangements (RFAs), which hold large and growing resources. Finally, we continue to count on the IMF at the center of the GFSN.



These diverse sources of supply correspond to the growing and diverse nature of the demand for foreign exchange liquidity in case of serious and lasting macroeconomic shocks. The challenges associated with the RFAs are well known and include 1) their adequacy in case of simultaneous shocks affecting the whole region; 2) their shortage of expertise and institutional capacity needed for surveillance and program design and monitoring, and 3) political impediments to imposing program conditionality.

Several years ago, there was a strong sense of fragmentation in the GFSN. We have seen some improvements in coordination between the IMF and the RFAs, but we are still at the very early stage of such a coordination process. Questions remain about the proper rules guiding access to foreign financing, about sharing data and information, about possibility of joint surveillance missions and provision of technical assistance. Moreover, there have been very few cases of testing such coordination in practice.

Proposals

First of all, G20 should be up to the task of providing effective oversight to secure global financial stability, and reaffirm the necessity of strengthening GFSN in a coordinated manner. Financial stability is public goods, which needs to be provided collectively by concerning countries. GFSN is one of the essential pillars for supporting a well-functioning international financial architecture. G20 as a political leaders' forum is in the right position to urge countries' policy makers and international financial institutions to work together in order to tackle the problems existed in current GFSN.

It's worth noting that each single country will have, in the emergency, different needs of assistance. But there exist objective indicators that show when the problem is serious so international help should be triggered. The IMF has a long history of development of early warning indicators to identify both domestic and external vulnerabilities. But it is always a challenge to make it effectively applicable for different countries. So G20 countries together with IMF could develop a set of national indicators of external vulnerability based on common methodology.

Secondly, since the IMF remains at the center of the GFSN, we need to take a closer look at the IMF itself. There is an ongoing discussion regarding the appropriate size of the IMF and the adequacy of its resources. On paper, overall resources available to the IMF may seem to be sufficiently large, but a big part of these resources are available on the basis of borrowing arrangements, such as the NAB (New Agreements to Borrow) and bilateral borrowing arrangements. All these borrowing arrangements



are only temporary and require a renewal every few years. Unfortunately, not all the major countries participate in such borrowing arrangements, which is creating an additional uncertainty regarding their timely renewal.

The discussion about the appropriate size of the IMF is taking place in the context of the discussion of the 15th general quota review. At the moment, the gap between calculated and actual quotas of the IMF members and various groups of such members has become very large and is growing every year. This is affecting the governance structure of the IMF. While the economic weight of the emerging market economies and developing countries is growing much faster than that of advanced economies, the governance structure is still reflecting the old structure of the world economy.

This whole situation is raising many questions regarding legitimacy, credibility, and effectiveness of the IMF and may encourage large emerging market economies to initiate the creation of alternative international financing options. To some extent, this is already taking place, with the BRICS countries establishing their own multilateral swap arrangements, as well as creating the pool of conventional currency reserves and the New Development Bank.

The lending instruments at the IMF's disposition require redesign in order to meet the need of member countries. The Flexible Credit Line (FCL) is a good example of IMF's reform on its lending forms and a change of the past strict conditionality. There are a significant number of emerging countries that could potentially benefit from such lending. This instrument, however, is underutilized. It is necessary to reconsider the incentives for countries to use it and at the same time to ensure that the lending should be directed to the countries with solid fundamentals.

Thirdly, to further explore the applicability of IMF's Policy Coordination Instrument (PCI). It is important to maintain its review-based approach and a certain degree of flexibility in terms of duration and frequency of dialogues between member countries and the IMF, in order to avoid the old IMF's stigma. But it is also necessary to keep high standards of monitoring criteria in order to achieve its goals of sending positive signals of committing reform so that the countries on PCI program could have better access to other regional or bilateral financial supporting network.

The three RTAs, namely, the ASEAN+3 Macroeconomic Research Office (AMRO), the European Stability Mechanism (ESM) and the Latin American Reserve Fund (FLAR), are strongly committed to collaboration in order to enhance the effectiveness of the GFSN. The first High-Level Dialogue of RFAs was held in Washington, D.C. in 2016. The heads of RFAs jointly decided to organize the regular High-level Dialogue to share information and experience among themselves and together with the IMF on an annual basis. Such decision was also in line with the G20 Hamburg Action Plan. In



2017, the second High-level Dialogue concluded with a joint statement, emphasizing the importance of the IMF's on-going work of formulating operational guidelines for IMF-RFA cooperation and how to tailor them to specific needs of each RFA. Such effort should continue and further be reinforced in response to changing financial conditions and vulnerabilities.

Fourthly, in the circumstance of the lack of unified pool of funding resource and joint surveillance, layered institutions and arrangements remain the second best options. Co-funding is a common form to tackle liquidity crisis in a country or cross-borders. RFAs shall play essential role in linking nation's self-insurance of reserves and global resources through speedy and accessible region-wide collective actions.

Specific attention should be attached to the experience of the European Union during the financial crisis, and particularly to the Greek crisis. It showed the relevance of RFAs and the links between the latter and the IMF. These links should be further investigated in terms of conditionality, timing, objectives to avoid inconsistencies and sub-optimal results.

Lastly, to consider a currency basket for supporting liquidity in time of crisis, supplementing the existing bilateral swaps. The six central banks' swap lines built on the US dollars have committed its permanent and unlimited funding support. It plays a crucial role as the need for liquidity ultimately is the need of US dollars. However, considering that diversification of international reserve currency is under the way, it would be suitable to meet the need of different currency components in short of liquidity, using a set of currencies in providing loans. Currently, the currencies in the IMF's SDR can be potential candidates for such consideration.

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