

## **THE GLOBAL FINANCIAL SAFETY NET AND INTERNATIONAL POLICY COOPERATION.**

**Javier Guzmán Calafell<sup>1</sup>**

The International Monetary and Financial System (IMFS) has been subject to a number of shocks during the last years that have compromised its adequate functioning. Indeed, the global financial crisis (GFC) made the weaknesses of the IMFS much clearer and highlighted the consequent need to reform it on several fronts. The liquidity provisioning function of the system, especially in times of crisis, is one of the most evident among them. Certainly, the severe shortage that took place during 2008-2009, and the swings that we have witnessed in subsequent years, have underlined that the current system needs better mechanisms to allow it to efficiently fulfill the liquidity requirements of the global economy during episodes of distress.

Financial and macroeconomic crises, as well as episodes of contagion to fundamentally sound economies, are inevitable and hard to predict. Hence the need for a sufficiently funded and evenly balanced Global Financial Safety Net (GFSN). This, not only because of its vital importance for the resolution of crises, but also, and perhaps even more important, because of the significant role it may play in their prevention.

Against the backdrop of persistently volatile international financial conditions, elevated risks to the global economy stemming from cyclical and structural developments, and the lack of sufficient space in both the fiscal and monetary policy fronts in many countries to accommodate potential shocks, the implementation of measures aimed at tackling the shortcomings affecting the current GFSN is of utmost relevance.

The experience of the last years has underscored the merits of holding a comfortable level of international reserves, the most immediate layer of the GFSN. However, reserve accumulation can also entail significant costs. At the country level, the financial burden deriving from the sterilization operations that need to be carried out in order to avoid the adverse macroeconomic implications of larger international reserves cannot be disregarded. At an international level, the excess demand for safe reserve assets contributes to global current account imbalances, introduces downward pressures on international interest rates, and may result in distortions of asset valuations;

---

<sup>1</sup> The views expressed in this document are strictly personal.

more leveraged positions by governments, firms and households; and a search for yield, all of which contribute to a more fragile, less stable IMFS.

Efforts to strengthen the GFSN should have the International Monetary Fund (IMF) at its center. Given its nearly universal membership, ample financing, and a wide range of facilities at its disposal, the Fund is in a unique position to play this role. However, for this to be a viable, fruitful path, further efforts in several areas are needed.

First of all, the IMF needs to have adequate resources. Standard indicators in this regard, such as the ratio of quotas to GDP, trade and capital flows, and international reserves, suggest that an additional quota increase is needed to endow the Fund with resources commensurate to potential demand. Unfortunately, the 15<sup>th</sup> General Review of Quotas will, in all likelihood, not lead to a quota increase. While an excessive reliance on borrowed resources would have important shortcomings, given the impossibility to adjust quotas at present, renewal of the New Arrangements to Borrow (NAB) and of the bilateral borrowing agreements in place should be sought with a view to at least maintain the total amount of resources currently available to the Fund.

The current characteristics of the world economy also underline the need for a financially strong IMF. The global economic and financial environment is bound to remain complex and highly uncertain for a significant period. Under such circumstances, the possibility of deeper, longer and more frequent crises is a real one. Moreover, the GFC has served as a reminder that advanced economies (AEs) may also require emergency liquidity, potentially implying large demands on the Fund.

Second, the IMF needs adequate financing tools. Indeed, the Fund has made significant progress in recent years to streamline the financial facilities available to its members. In addition to the more traditional, crisis resolution-oriented facilities it has historically offered, a number of instruments (such as the Flexible Credit Line and the Precautionary and Liquidity Line) were created after the eruption of the GFC, with a stronger focus on crisis prevention and higher, more expedite access. Unfortunately, demand for these instruments has in general been modest. While there is still room to improve some of the features of the available financing windows, this is unlikely to provide the full explanation for their limited use. Although the reasons for this are clearly varied, one crucial element behind the reluctance to demand Fund support is the stigma associated with the use of the institution's resources. Clearly, the

search for means to overcome this complex problem must continue, especially in view of the potential benefits for the world economy of a more intensive use of financing frameworks that deter crises.

Third, the IMF has to be seen as a legitimate body. In particular, an important gap between emerging market economy (EME) participation in the global economy and their IMF quota and voting share remains. Furthermore, a modification of criteria for the designation of the Fund's top management has been disregarded. In the absence of further reform of Fund governance, the institution's credibility will be eroded, while the proliferation of alternative schemes for international cooperation will possibly continue, thus undermining the Fund's role in the world economy and further entangling global governance.

Naturally, a reliable and efficient GFSN cannot depend on IMF funding alone. An adequate functioning of the other layers is also essential. In addition to the above-noted role of international reserves, the other two components of the GFSN are bilateral swap lines and regional financial arrangements.

Bilateral swap agreements played a crucial role in stabilizing markets during the early stages of the GFC. Other features, such as their relative low cost and speed of access, also contribute to make them an attractive vehicle for liquidity support in times of stress. Not surprisingly, then, some countries have suggested the institutionalization of swap lines. This is a sensible proposal since, to become a useful component of the GFSN, swaps need to be a credible source of liquidity in case of need. The negotiation of swap agreements *ex post*, though useful, does not meet this requirement.

Nevertheless, bilateral swap arrangements involve risks for the party providing the liquidity that are not easily dealt with through the use of collateral. In addition, there is a concern among reserve currency issuers that the *ex ante* commitment by central banks to provide bilateral swap lines may give rise to moral hazard. As a result, these institutions have been reluctant to participate in arrangements of this nature with EMEs, thus preferring to adopt a "constructive ambiguity" approach.

While these concerns are understandable, considering the potential contribution of an institutionalized network of swap lines to the GFSN, options to increase its feasibility should continue to be explored. One possible course of action that deserves to be looked at is a mechanism including qualification

criteria, sanctions and monitoring, coordinated jointly by the participating reserve currency issuing central banks and the IMF.<sup>2</sup> Another simpler option is to condition country access to swap arrangements to an IMF “stamp of approval”, be it through a formal program or other acceptable means. Naturally, IMF involvement could imply costs in terms of stigma and speed of access, but this would still be a superior option to the status quo.

Regional financial arrangements (RFAs) can also make an important contribution to the functioning of the GFSN. Beyond the increased amount of resources available to face potential crises, they may allow a better understanding of the participating economies and a higher degree of ownership of economic adjustment programs. As shown by the experience of the European Financial Stability Facility and the European Stability Mechanism, this kind of arrangements can play a crucial role in times of severe stress.

Nevertheless, RFAs are also affected by a number of shortcomings: their resources are unequally distributed, with many countries having no access to this source of financing; while they can be a useful source of support to tackle problems faced by individual economies, major limitations may arise in case of shocks of a global or regional nature; flexibility in the use of resources may be limited; and, very importantly, the reliability of most of these arrangements beyond short-term periods has never been tested.

It is not easy to make recommendations of a generalized application to improve the functioning of RFAs, since they constitute a very heterogeneous group. In my opinion, the most important course of action of a general nature is to put in place the conditions for a better coordination with the IMF. Several suggestions have been made to this effect over the last years, including at the level of the G20, with the recent case of the euro area providing a useful experience. But the reality is that a more formal framework for cooperation between the Fund and RFAs; focused on a rational division of responsibilities and a proper assimilation of synergies, is still missing.

It is difficult to expect that a transformation of the GFSN will be thoroughly addressed anytime soon, given difficulties of a political nature and the sheer complexity of some of the issues raised. In the absence of a stronger, more efficient GFSN, efforts to accumulate international reserves are likely to

---

<sup>2</sup> See Fahri, Emmanuel, Pierre-Olivier Gourinchas and H el ene Rey (2011): “Reforming the International Monetary System”, Center for Economic Policy Research e-Book.

continue, with the corresponding costs at the national and global levels. Hopefully, as awareness of the disadvantages of this strategy increases and the merits of a solid GFSN become more evident, efforts to follow the proper course of action will gain ground.

Naturally, though crucial under current conditions, the GFSN is only one piece of a major effort of monetary cooperation needed in the world economy to tackle current risks. Although the main responsibility lies in domestic policies, it is undeniable that the magnitude of the challenges faced calls for increased cooperation of the international community.

As history has shown, policy cooperation at the international level is particularly strong during episodes of crisis and severe economic and financial distress. Indeed, outside such episodes, the case for cooperation tends to fade, as its benefits become less evident and policymaking therefore has even stronger incentives to favor national over multilateral considerations.

Although the usefulness and feasibility of international policy cooperation is a subject of debate, its merits outweigh by far its potential disadvantages. In fact, the GFC provides unquestionable evidence in this respect, since its costs would have been much higher in the absence of cooperation. More generally, the following can be underlined:

- From a theoretical point of view, the existence of spillovers implies the presence of externalities. If not taken into account properly, i.e. internalized, the latter will imply inefficient results. In other words, policy cooperation is needed. This applies even under flexible exchange rates, since they do not fully insulate countries from external shocks.
- The close linkages and interconnections currently existing in a highly-interdependent global economy set the stage for a spillover-rich environment, as shocks and policy choices in one country or region are easily transmitted to the rest of the world.
- The analysis of the nature, magnitude and direction of spillovers from monetary policy can be further complicated by the use of unconventional monetary policy measures. Additional challenges relate to potential spillovers from the prolonged use of, and subsequent exit from, these measures.
- External shocks resulting from spillover effects will normally be absorbed to a significant extent through exchange rate adjustments in

those countries with flexible rate regimes. However, the empirical evidence shows that, after a certain threshold, the depreciation of a currency can have non-linear effects on inflation and other macroeconomic variables.

- A situation of uncertainty, like the one we face today, enhances the case for policy cooperation since, by increasing volatility, it is equivalent to an additional spillover effect.

When considering the possible areas for enhanced international monetary cooperation, paradoxically, there are actions at the national level in AEs that can be seen as a way of international cooperation in view of their potential global repercussions.

The first one relates to communication. In the current setting, a latent source of spillovers derives from a still-substantial degree of uncertainty regarding the future course of monetary policy in AEs. In particular, market anxiety revolves around the timing and path for exit from the unconventional measures, and the overall normalization of the monetary policy stance in those economies. In order to contain the risks to macroeconomic and financial stability that may ensue, a clear and effective communication strategy takes center stage. Although significant progress has been made in this regard in recent years, the misunderstandings that we have continued to see regarding possible monetary policy actions in some AEs are a reminder of the extreme market sensitivity to their central banks' remarks.

The second one has to do with the policy mix in AEs. The policy response in these countries to the GFC has relied excessively on monetary policy, without adequate support from fiscal and, especially, structural adjustment measures. In the absence of alternative sources of support for economic activity from either the demand or the supply sides, interest rates have been lower than we would have seen under a more balanced policy mix, thereby giving rise to stronger international spillovers.

Beyond these actions at the national level, many possible options exist to enhance policy cooperation from a strictly international point of view. Some of them can be implemented relatively easily. In other cases, however, a strong political will and an awareness of the self-interest deriving from international cooperation would be required. A few examples deserve to be underlined:

- AEs need to be fully aware of the international repercussions of their

monetary policy actions. Failure to recognize the extent and magnitude of the associated spillovers exacerbates the difficulties that the economies abroad, particularly EMEs, may face. This also complicates matters for AEs, since spillovers can have a boomerang effect. Although some progress has been made in this regard, this is still far from satisfactory. AEs should regularly carry out deeper evaluations of the cross-border and boomerang repercussions of their policy choices.

- Closely linked to the above, we need more research on monetary policy spillovers and spillbacks from different sources. It is widely agreed that our understanding of this issue is relatively modest. However, efforts to overcome this situation are still insufficient. This is a task that should be undertaken by multiple parties, including international institutions, advanced as well as emerging market economies, and academia. The input of many sources of research is particularly important given the potential for contradictory conclusions from the studies carried out by official sources from the involved countries.
- As noted above, we need a strong, efficient and adequately funded GFSN.
- Although surveillance mechanisms have been well-established for long, their failure to timely identify the build-up of macroeconomic and financial risks and imbalances leading to the GFC, is a clear indication of their lagging behind with respect to the increasing and complex interlinkages across both countries and policies. The multilateral and domestic efforts that have since taken place in order to expand and strengthen surveillance are welcome. However, if these monitoring mechanisms are to represent a fundamental piece of international policy cooperation, a number of challenges need to be properly addressed. One of them is related to the importance of a better understanding of the spillovers and boomerang effects mentioned before. Another is the need for increased efforts towards the formulation of more explicit, unambiguous recommendations for avenues of international policy cooperation, together with adequate coordination between the institutions involved—for instance through the IMF—and a periodic follow-up of results achieved.

The challenges for surveillance are further compounded by the difficulties to

compel participating countries to adhere to the derived policy and cooperation proposals. To this end, pure peer pressure, although desirable and helpful, has proved to be insufficient. On the other hand, a compulsory approach would understandably be rejected in view of its implications for sovereignty. Ex ante agreed sanctions have been tried in regions with a strong political commitment to integration. However, as is well known, even in these isolated and difficult to replicate cases, the results have been so far unsatisfactory. The difficulties linked to efforts to furnish the surveillance function with “teeth” are illustrated by the reluctance of some multilateral institutions to use tools legally available to them, but with potentially controversial implications. This is clearly a very complex subject, but we should continue to search for efficient enforcement mechanisms, and at least encourage international institutions to draw upon all instruments at their disposal whenever needed.

In the face of a world economy which is improving but that still faces formidable challenges, the need to supplement any required domestic policy efforts with international cooperation should not be the subject of much debate. There are many possible avenues to move in this direction, with a varying degree of complexity. Unfortunately, notwithstanding the measures adopted as a result of the GFC, as in previous similar episodes the drive towards cooperation has lost considerable force. The consequent risks are obvious.