GLOBAL FINANCIAL SAFETY NETS

Stephen Pickford, Associate Fellow Chatham House

Introduction

The global crisis which began in 2007 has highlighted the ongoing need for effective mechanisms to help resolve country problems, especially when crises are systemic. Although the recent crisis began in advanced economy financial sectors, it rapidly spread (through the fiscal accounts) to sovereign problems, especially in smaller countries with relatively large financial sectors.

Having made the jump to national balance sheets, global financial markets enabled the crisis to spread rapidly across national boundaries. The nature of crisis propagation and contagion in the increasingly interconnected world has been extensively documented. Recent work by the IMF shows that while systemic crises tend to originate in large or more integrated economies, but are rapidly transmitted across national boundaries through trade and financial interlinkages ('Analytics of systemic crises and the role of global financial safety nets': IMF, May 2011).

The immediate response to the global crisis by the international community was to use existing mechanisms to channel finance to affected countries, initially through IMF lending and then (as the crisis spread through Europe) through European mechanisms. IMF resources were substantially increased following the London G20 Summit in April 2009. Also new types of program, which made use of the greatly enhanced financial resources, were quickly introduced, in particular the IMF's FCL and PCL, and the European EFSF and ESM.

But despite these innovations, the shortcomings of existing crisis resolution mechanisms have been fully exposed over the last three years, at the national, regional and global level. Even the new IMF FCLs, which were intended to protect countries against contagion and require no conditionality, were only taken up by three countries. And as contagion spread, more countries became exposed to market pressures and faced severe financing difficulties.

The case for global financial safety nets

This has led to repeated calls, not least from the G20, for more effective and more far-reaching mechanisms -- 'global financial safety nets'.

The motivation for these calls is clear from the experience of the last three years:

- After almost a decade when crises were largely absent, and when it appeared (wrongly, in retrospect) that risks were being reduced through diversification, the catastrophic drying up of liquidity world-wide reemphasised the need for global and coordinated solutions

- Exacerbated by deeper cross-border financial linkages, there were unprecedented spillovers from the core crisis countries to a whole range of other countries, many of whom had been seen as having strong fundamental positions and policies – the 'innocent bystanders'
- The perceived failures of crisis resolution mechanisms in previous episodes (especially in the Asian crisis of the late 90s) had been one reason – though only one of a number of reasons[1] – why many emerging markets had built up national foreign exchange reserves as a way to self-insure against future crises. The resulting current account imbalances, capital outflows from emerging markets and capital restrictions on inflows were seen as a contributory factor behind the exceptionally low global interest rates, the 'search for yield', and asset bubbles in many advanced economies in 2006 and 2007.

So, because there was a lack of effective resolution mechanisms which led to increasing imbalances in the global economy, this is seen as having helped sow the seeds of the next crisis.

These developments help explain the renewed policy interest in global financial safety nets. In the literature there seem to be somewhat different views about what these are (or should be). But the most common view is that there should be global mechanisms to:

- Provide fast-disbursing financial assistance in large amounts to countries open to global capital markets and facing liquidity problems (in particular the 'innocent bystanders')
- Reduce the demand for self-insurance through reserves accumulation, by providing a realistic and attractive alternative safety net to countries
- Reduce the need for restrictions on capital inflows (which are seen by some emerging markets as another protective mechanism against destabilising market movements)
- And reduce global imbalances, which ultimately is seen as crucial for global growth.

<u>Liquidity vs solvency</u>

In looking at the definition and design of financial safety nets, distinguishing between liquidity and solvency problems is (as always) important. If a country is seen as an innocent bystander, it follows (almost by definition) that it faces a liquidity (not a solvency) problem since it was seen to have strong fundamentals but was simply caught in the cross-winds.

[1] There have been fierce debates as to how far the reserves build-up in emerging markets was due to the desire for self-insurance, and how far it reflected a deliberate policy to maintain under-valued exchange rates as a way to stimulate export-led growth. Whatever the relative strength of these motives, the outcome in terms of (actual or threatened) currency wars is clear.

But the last crisis has shown again that the distinction between liquidity and solvency problems is not at all clear-cut. Liquidity problems tend, if they last for any length of time, to morph into solvency problems. This is as true at the country level as it was for banks in 2007 and 2008, not least because high sovereign borrowing costs can quickly lead to unsustainable fiscal positions. Proponents of stronger financial safety nets see this as further justification – if problems that start out as liquidity-related can become solvency issues, dealing with them in their early stages helps avoid the more damaging (and costly) later stages.

Enhanced safety nets

Existing mechanisms for dealing with crises were seen, especially in the early stages of the crisis, as ineffective in two respects:

- Insufficient amounts of financial 'fire-power' to provide sufficient liquidity to offset private outflows and convince markets, and
- Insufficiently flexible (and quick) ways to disburse funds, so that the facilities were not attractive enough for countries to apply for them sufficiently early.

The level of financial resources available for support operations has been increased substantially in the last two years, first through the tripling of IMF resources agreed at the London G20 Summit in 2009, and second through the creation of European mechanisms to support countries in crisis (the EFSF and the ESM). [*Chiang Mai?*] But even after these initiatives the total quantum of multilateral financial fire-power available through the IMF, the European mechanisms, and the Chiang Mai Initiative had done little more than keep pace with GDP growth globally, at around 2-3 percent of global GDP (and fallen far short of the increase in global trade and financial flows). The IMF estimate that ('Strengthening the International Monetary System: Taking Stock and Looking Ahead': IMF, March 2011). During the crisis central bank swap arrangements with the US Fed added at the peak another $600 billion to the available resources (as well as 250 billion euros in swaps provided by the ECB).

But by far the largest element of resources available to countries are national reserves, which have grown in total over the last ten years from about 5 percent of global GDP to 15 percent now. However, these resources are spread very unevenly, and (not coincidentally) tend to be concentrated in countries which are less likely to suffer financing problems. They are also costly for countries to maintain, with (usually) substantial carry costs. And (as noted earlier) have contributed to the growth of global imbalances.

IMF financial instruments were also made more flexible, and better designed to be taken up by the innocent bystanders (the creation of the FCL and its subsequent reform, and its somewhat less flexible sibling the PCL). The FCL is designed to provide access to very substantial amounts of financing on a contingent basis for countries with 'very strong policy fundamentals and frameworks', to be drawn down as needed but without any further review or conditionality once a country has qualified. The PCL is designed for less strong countries, and requires some extra conditionality when funds are drawn on.

But there is still a widespread view that more needs to be done. The amount of money available is still not seen as sufficient to deal with another episode on the scale of the 2007 crisis (especially if the Eurozone crisis gets worse and eats further into the available resources). And the extremely limited take-up of the FCL and PCL suggests that they are still not fulfilling their desired role as ways to head off liquidity-induced pressures leading to a loss of market confidence.

Ideas for ways to strengthen the toolkit fall into a number of categories (each of which are designed to boost financial clout or be more user-friendly, or both). And they range from 'more of the same' (improving and enhancing existing mechanisms) to radical new mechanisms.

At the 'more of the same' end of the spectrum:

- Ways to further augment IMF resources (SDR allocations; borrowing from countries; borrowing from markets)
- Ways to harness and combine different sources of finance (IMF; central bank swap arrangements; regional financing arrangements)

At the more radical end:

- Ways to make access to Fund borrowing more automatic (the GSM)
- A global swap network
- Formal ex ante cooperation mechanisms between the IMF and RFAs

An international lender of last resort?

And there are increasing calls for an 'international lender of last resort' (ILLR), by analogy with the classical role for central banks to play in supporting essentially solvent banks which are faced with liquidity shortages. This idea has been around at least as far back as the 1990s[2].

Apart from the problems of distinguishing between liquidity and solvency as the root cause, the analogy with banks does not work very well for countries. The classical conditions for a domestic lender of last resort role, as set out by Bagehot, were that central banks should (i) lend unlimited amounts of liquidity to solvent banks, and (ii) take good collateral. Countries facing severe financing problems typically only have good quality assets in the form of foreign exchange reserves, which are unlikely to be available for pledging to an ILLR. Also, in practice central banks often insist on fundamental changes to management when bailing out banks; again, this is not possible

[2] Stan Fischer proposed just such a role for the Fund in the aftermath of the Asian crisis.

when applied to sovereigns (though changes to government policy under Fund programs can have a similar effect).

Nevertheless, at heart the concept of an ILLR is not substantially different from the other elements identified above. They are all intended to:

- Make available substantial amounts of fast-disbursing finance with relatively little (or no) conditionality
- To countries not needing substantial policy adjustment.

Moral hazard

Critics of any expansion in the crisis resolution toolkit cite moral hazard. Views on how problematic this is vary enormously. My own reading of the global crisis is that markets were fully capable of excessive risk-taking even when there were imperfect and insufficient crisis resolution mechanisms. The greater risk is not having an effective toolkit.

Excessive private sector risk-taking is clearly a potential problem (and was a very real actual problem in the run-up to the 2007 crisis, and in most other systemic crises). But the presence or absence of effective international lending facilities does not appear to have had a marked effect on private sector behaviour. However, the solution does not lie with the design of IMF programs, but excessive risk-taking should instead be addressed through reforms to financial regulation and supervision.

The other moral hazard argument is that making IMF financing available to countries on 'easy' terms, with little or no conditionality, will encourage poor national policies. Again, in my view this argument is overstated. The truly low conditionality facilities (the FCL and, to a lesser extent, the PCL) have only recently been introduced, so there is little evidence to go on. But the three countries which have taken up the FCL were all considered to have exemplary policies. The problem has not been too many countries of the 'wrong sort' taking out FCLs, but rather that demand from the 'right sort' of countries has been insufficient.

Conclusions

Existing mechanisms are insufficient to deal with another event on the scale of 2007-09. The systemic nature of the recent crisis highlighted the weaknesses of the current patchwork of mechanisms to protect countries from extreme liquidity pressures. The IMF's resources were substantially augmented in 2009, but a significant proportion remains committed to programs. The European and Asian regional mechanisms have also been added to very significantly, but much of the EFSF funds have already been used for the programs for Ireland and Greece. And central bank swap lines were introduced only as a last resort at the height of the crisis, and were wound back quickly.

And countries are generally starting now from a much weaker position to be able to withstand such pressures. Countries are still counting the cost of the crisis. In many cases their fiscal positions are much more fragile than they were four years ago, in terms of both deficits and debt levels. And the loss of output and slow growth make them more vulnerable to financing difficulties.

The problems lie with both the quantum of finance available and the mechanisms for disbursing it. Apart from the scale of resources which would be needed to deal with a global systemic crisis, mechanisms are required that could disburse funds very rapidly, at scale, and which countries would be prepared to sign up to before a liquidity shortage started to turn into a solvency problem.

It is also not prudent to rely on one solution. The size of the potential problem, and the political difficulties that would be involved in reaching agreement on a single mechanism of sufficient size, point towards trying to make progress on a number of fronts. This 'menu approach' may not be the most efficient, and there would clearly be problems that would need to be resolved in coordinating across different mechanisms. But the experience of the recent crisis suggests that the coordination problem is much less severe than the problem of putting new mechanisms in place in the middle of a crisis. The difficulties faced by the US Administration in getting Congressional approval for the TARP is a case in point.

On financing, the most promising approaches appear to be:

- **to set in place mechanisms for the IMF to borrow from the markets.** The Fund's Articles already permit it to borrow from capital markets, though to date it has never done so. The fiscal constraints currently faced by most of the potential sovereign lenders to the Fund (ie the NAB participants) suggest that other forms of financing for the Fund need to be found. Also, market financing in the face of a global systemic liquidity shortage (as in the recent crisis) is a logical solution. If markets are afraid to lend to entities that are seen as risky (whether banks or sovereigns), it should be possible for the Fund to borrow relatively cheaply, and probably more cheaply than many of the NAB members could in those circumstances. It would also help stabilise market uncertainties if there were an institution that was seen as 'cast-iron' providing a place for investors to put their funds. In effect the Fund would be multilateralising, and moving up to a sovereign level, the role that many central banks played in the recent crisis in intermediating between private sector borrowers and lenders.
- **to reach ex ante agreements with central banks for a network of swap arrangements**. The experience of the crisis was that at the height of the turmoil these swap lines were crucial in reducing market disruptions and restoring a measure of confidence. The Fed swap lines with Brazil, Korea, Mexico and Singapore were particularly effective in restoring a measure of confidence to these countries. But these arrangements were very ad hoc, and relied on the

willingness of the Fed to use a substantial portion of its balance sheet in this way. Multilateralising such a mechanism, with clarity over amounts, recipients and rules for activation would provide a clearer signal that liquidity would be available if needed, and could help prevent market pressures building up excessively.

- **to formalise links between the IMF and the RFAs, especially the EFSF/ESM and Chiang Mai Initiative**. The CMI has gone a long way down this route already, with the bulk of its financial resources available only in conjunction with a Fund program. The Fund is also heavily involved with AMRO, the new analytical body being set up in Singapore to support the CMI. Within Europe all current support operations have been carried out jointly with the IMF. But there has been reluctance on the part of the European institutions to this link, and if anything they are moving to a position of wanting to be able to operate independently of the Fund. This would be a mistake, not only because of the resources that the Fund can bring to the table (and most commentators judge that even when the ESM is fully operational in 2013, it would not be able to cope with support operations for countries the size of Spain or Italy); but also the Fund has considerably more expertise and credibility in designing programs.

On instruments:

- **using Article IVs to decide prequalification.** The issue of pre-qualification for the FCL and PCL has been a fraught one. On the one hand some argue that pre-qualification should be automatic; others argue that this would generate massive moral hazard and expose the Fund to unsustainable financial risk. The right conclusion is somewhere in the middle. In the circumstances where countries (the 'innocent bystanders') are likely to want to access these facilities – and there will still be some stigma attached to their use – the premium will be on rapid disbursement in large amounts. That requires some degree of pre-qualification, but without countries applying in advance of need. The obvious mechanism for managing pre-qualification in advance of application is the annual Article IV process. Whether the judgements about which countries meet the qualification criteria are made public is a difficult issue, and the balance may well shift as a crisis unfolds. Even more difficult is the problem of countries which do not qualify. Nevertheless the benefits of having a core of countries which are seen as well-protected against spillovers from systemic crises are immense.
- **making clear ex ante the scale of resources that could be made available.** To date the normal rules on access to Fund resources have gone out of the window. This has been a good thing since it has avoided the situation where Fund programs have been prevented by access limits from providing enough funds to resolve the crisis. But finding some way to scale the resources available, even if only approximately, would be helpful. Not only would it go some way towards establishing a limit to the Fund's exposure. But it would also (if

sufficiently large) provide confidence that the resources were available to see countries through the crisis, and thereby help prevent the crisis from spreading.

There are no guarantees that reforms along these lines will be sufficient to avoid similar crises in future. But the costs of a repeat of 2007-10 make it worth trying to reduce the risk of it happening, and (if it does) minimising the dislocation.