

REMARKS BY MR. JAVIER GUZMÁN CALAFELL, DEPUTY GOVERNOR AT THE BANCO DE MÉXICO, AT THE 7TH ANNUAL CONFERENCE OF THE BANCO CENTRAL DE RESERVA DEL PERÚ AND THE REINVENTING BRETTON WOODS COMMITTEE. SESSION ON “UNCERTAINTIES ABOUT THE GLOBAL FINANCIAL SAFETY NET”, Arequipa, Peru, 6 July 2016. ¹

I am very glad to participate in this 7th Annual Conference of the Banco Central de Reserva del Perú and the Reinventing Bretton Woods Committee. I thank Julio Velarde and Marc Uzan for the invitation to attend this event.

Over the last several years, the International Monetary and Financial System (IMFS) has been subject to a number of shocks that have compromised its adequate functioning. Indeed, the global financial crisis 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 liquidity shortage that took place during 2008-2009, and the swings in global liquidity that we have witnessed in subsequent years, have underlined that the current system needs better mechanisms to allow it to fulfill, in a systematic, timely and efficient manner, the liquidity requirements of the global economy during episodes of distress.

The demand for emergency liquidity in the global system should decline to the extent that appropriate macroeconomic and financial policies are in place. However, the reality is that financial and macroeconomic crises, as well as episodes of contagion to fundamentally sound economies, are inevitable and

¹ The views expressed in this document are strictly personal.

hard to predict. Hence, the need for a sufficiently funded and evenly balanced Global Financial Safety Net (GFSN) should not be overlooked. 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.

The GFSN has undergone a profound transformation as a result of the global financial crisis of 2008-2009. To start with, in view of the prevailing uncertainty and in an effort to protect themselves against external risks, many countries decided to increase substantially the size of their international reserves. In addition, the financial resources available to the International Monetary Fund (IMF) were enlarged and its financial facilities revamped. Simultaneously, a number of new regional financial arrangements (RFAs) were created with some of the existing ones strengthened. Finally, in an effort to tackle liquidity shortages, central bank bilateral swap arrangements (BSAs) were made available to many countries. Although distinct in nature, these four layers constitute the general structure of the GFSN as it currently stands.

Notwithstanding its recent transformation, the GFSN still faces important challenges. First and foremost, even though its financing potential has increased substantially in recent years, this is mostly explained by reserve accumulation which, as explained below, has a number of drawbacks. In fact, once international reserves are excluded, the evolution of GFSN resources does not keep pace with the growth of global external liabilities in recent

years.² Furthermore, the GFSN's ability to prevent contagion is undermined by its uneven country coverage, as sizeable financing gaps in many economies still remain unattended. In addition, the growing size and complexity of the GFSN, in particular the proliferation of bilateral and regional arrangements, has led to greater difficulty in coordinating its various components, thus resulting in a more fragmented, less reliable framework. To this one must add high costs, either of a financial or political nature, of several layers of the safety net, and the absence of an appropriate conditionality structure in most of these layers, implying the potential of inadequate policy incentives and moral hazard, among other risks.

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. In the absence of decisive action in this direction, we may see increasing risks for the global financial system and an additional accumulation of international reserves by individual countries.

The experience of the last years has underscored the merits of holding a comfortable level of international reserves. However, reserve accumulation can also entail significant costs. At the country level, the financial burden

² See International Monetary Fund (2016): "Strengthening the International Monetary System-A Stocktaking", IMF Policy Paper, February.

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. Such costs are potentially high due to the uncertainty surrounding the definition of an adequate, or optimal, level of international reserves, in light of which a precautionary over accumulation becomes more likely. 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 in the valuation of assets; more leveraged positions by governments, firms and households; and a search for yield, all of which contribute to a more fragile, less stable IMFS.³

What should the international community do to strengthen the GFSN?

With an emerging market perspective in mind, from my point of view any strategy in this direction should have the International Monetary Fund (IMF) at its center. Given its nearly universal membership, ample financing, a wide range of facilities at its disposal, and a highly qualified and experienced staff, 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. Let me point to three of them which I consider to be particularly important.

³ See Denbee, Edd, Carsten Jung and Francesco Paternò (2016): “Stitching Together the Global Financial Safety Net”, Bank of England Financial Stability Paper No. 36, February.

First of all, the IMF needs to have adequate resources. Certainly, the recent doubling in Fund quotas under the 14th General Review, the largest ever, is a major step in this direction. However, it should be noted that the net effect of this measure on the Fund's overall lending capacity is negligible, vis-à-vis the amount available with the previous quota base and the borrowing agreements negotiated in the aftermath of the global financial crisis. Furthermore, standard indicators of the adequacy of Fund resources, 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. While an excessive reliance on borrowed resources would have important shortcomings, this source of funding has played a useful role when capital has to be mobilized swiftly. In this regard, it is also important to emphasize that renewal of the New Arrangements to Borrow (NAB) for the five year period starting in 2017 has yet to be discussed and agreed upon, and that there is a risk that the bilateral borrowing agreements set forth in 2012 will not be extended and thus start to expire later this year.

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. Not only are linkages among individual economies expected to continue growing, but also legacies from the crisis in a number of key, systemic players are likely to persist. Under such circumstances, the possibility of deeper, longer and more frequent crises is a real one. Moreover, the global financial crisis has

served as a reminder that advanced economies (AEs) may also require emergency liquidity, implying potentially 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 were created after the eruption of the global financial crisis, with a stronger focus on crisis prevention and higher access (the Flexible Credit Line and the Precautionary and Liquidity Line). Unfortunately, demand for these instruments has in general been modest.

While I concur with the view that there is still room to improve some of the features of the available financing windows, this is unlikely to provide the explanation for their limited use. Take the case of the FCL. The features of this facility in terms of access and flexibility of resource use, among others, would have simply been unthinkable before the global financial crisis. Yet, only three countries are at present supported by the FCL. This situation is paradoxical, since some potential FCL beneficiaries would clearly profit from the availability of additional external liquidity.

Although the reasons for this are clearly varied, one crucial element behind the reluctance to demand Fund support is the stigma associated with use of the institution's resources. This is related to factors such as the historical relationship with the IMF, the perceived success (or lack thereof) of Fund

programs, the conditionality typically associated to them, the political sensitivities of each country and the legitimacy of Fund decision making, among others. 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 stimulate crisis prevention. I would like to note in this regard that the FCL has been instrumental to support macroeconomic and financial stability in Mexico through several channels, including the availability of large amounts of external financing in case of need, lower costs of international reserve accumulation, endorsement of the country's policies under the most strict Fund standards and a reinforcement of the authorities' commitment with sound fundamentals.

Third, the IMF has to be seen as a legitimate body. The recent implementation of the quota and governance reforms under the 14th General Review of Quotas, has implied a major shift, of around 6 percent points, in both quota shares and in voting power towards dynamic EMEs. Additionally, the IMF's Executive Board will now consist entirely of elected Executive Directors, effectively ending some countries' ability to directly appoint members of the Board.⁴ These are major steps forward, but still insufficient. In particular, an important gap between EME participation in the global economy and their IMF quota and voting share remains, even after taking into account the recent reforms: as a group, EMEs accounted for nearly 60 percent of world GDP (in

⁴ See International Monetary Fund (2016): "Historic Quota and Governance Reforms Become Effective", Press Release No. 16/25, 27 January.

PPP-adjusted terms) in 2015, while they contribute only slightly over 40 percent to the IMF quotas under the current arrangements. 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. I already referred to the role of international reserves. Therefore, let me say now a few words about the other two components, namely bilateral swap lines and regional financial arrangements.

The number of central bank swap lines increased sharply in the early years of the global financial crisis, including arrangements between advanced economies only and also between advanced and a few emerging market economies. In subsequent years, a small group of advanced economies decided to maintain bilateral swaps among them as a means to face the risk of new liquidity shortages. However, those negotiated with other advanced and emerging market economies were allowed to expire.⁵

⁵ Since late 2008, an extensive global network of renminbi swap lines with China has emerged, but this is concentrated on supporting trade with and investment from China, and promoting the international use of the renminbi.

Bilateral swap agreements played a crucial role in stabilizing markets during the early stages of the global financial crisis. 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 emerging market economies, 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.⁶ Another simpler option is

⁶ See Fahri, Emmanuel, Pierre-Olivier Gourinchas and Hélène Rey (2011): “Reforming the International Monetary System”, Center for Economic Policy Research e-Book.

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.

Let me turn now to RFAs.

Although frameworks aimed at providing financial support to countries in difficulties with resources pooled at a regional level have existed for many years, the importance of RFAs as a layer of the GFSN increased substantially following the global financial crisis. According to some estimates, the total amount of resources currently available through RFAs amounts to US\$1.2 trillion, i.e. a lending capacity at least in theory somewhat above that of the IMF at present.⁷

Indeed, RFAs can 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.

⁷ See International Monetary Fund (2016): “Adequacy of the Global Financial Safety Net”, IMF Policy Paper, March; and Cheng, Gong (2016): “The Global Financial Safety Net through the Prism of G20 Summits”, European Stability Mechanism Working Paper No. 13, April.

Nevertheless, RFAs are also affected by a number of shortcomings: their resources are unequally distributed, with many EMEs having no access to this source of financing; while they can be a useful source of support to tackle problems faced by individual countries, 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 Europe 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.

To conclude, I just want to note that it is difficult to expect that a transformation of the GFSN along the lines suggested here will be thoroughly addressed any time 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 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.