THE TRANSFORMATION OF GLOBAL GOVERNANCE PROJECT

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THE GOVERNANCE OF GLOBAL FINANCIAL SAFETY NETS: FIT FOR PURPOSE?

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1. **Financial globalisation has reshaped financial interdependence and increased the demand for global financial safety nets.** The IMF-centred safety net of the post-war decades was quantitatively and qualitatively adequate in a world of limited capital flows and mostly national banking. It does not respond to the needs of a world of unfettered capital flows, global value chains, market interdependence and international banking. Under such conditions, global financial safety nets must consist of several coordinated layers whose combination matches the potential needs of financially open countries.

   The current international regime departs from the 1990s template in fundamental ways. Capital flows are increasingly driven by push factors resulting from the global financial cycle and US monetary policy, rather than pull factors from domestic policies. Ergo, while conditional assistance remains the right response to capital outflows from domestic policy errors, it may not be the right response to externally-driven boom-bust financial cycles and self-fulfilling crises. At the same time, in times of stress, commercial banks doing business in foreign currency face liquidity shortages but may lack adequate foreign currency collateral, needing access to an international lender of last resort.

2. **Economic and political reasons explain why the IMF alone cannot respond to such needs.** Tackling financial account crises may require amounts of financial assistance that exceed by a wide margin what the multilateral system can realistically mobilise. Whereas the overall pool of resources available for international financial assistance has tripled in proportion to world GDP, IMF permanent resources represent only one-eighth of available resources excluding national reserves. In addition, whereas IMF governance correctly limits the politicisation of lending, it also limits availability of precautionary support. Despite attempts to broaden the scope of its facilities, the Fund is not yet well equipped to provide unconditional liquidity to prequalified countries. Stigma effects and a reluctance to move away from conditional lending explain why it has not succeeded.

   The IMF is also not better prepared to provide liquidity support to commercial banks operating in foreign currency. Covering such needs is an extension of the traditional role of central banks acting as lenders of last resort to commercial banks. They cannot be substituted in this role by an international institution. By the same token, the Fund cannot exercise conditionality towards central banks providing liquidity to their banking sector. Speed and scale require this operation to be based on trust.

3. **Massive accumulation of reserves at national level is indicative of pervasive distrust in the multilateral Bretton Woods system.** Reserves-to-GDP and reserves-to-trade ratios have reached unprecedented levels. Preference for such costly self-insurance, most notably in Asia where it emerged in reaction to the Asian crisis of the late 1990s and the IMF programmes that followed. Its rise amounted to a first major departure from the principle of mutual insurance embodied in the IMF articles of agreement. It signalled that several emerging countries regarded the Fund as excessively driven by the perspective, and even the interest of the advanced Western countries.

4. **In a significant departure from the established multilateral regime, a three-layer system has come into existence.** In addition to national reserves, it consists of:

   - *Bilateral support schemes, especially through swap lines.* Such swap lines may serve as confidence-signalling devices, macro-financial support, trade- or currency-promoting instruments, or channels of provision of international currency liquidity to banks ;
   - *Regional safety nets* to provide financial assistance to participating countries. There are by now seven, uneven in terms of size, institutional infrastructure and potential effectiveness, developed in part for resources, in part in response to IMF mistrust;

- *Multilateral financial assistance* through the IMF, in the form of traditional conditional assistance or of liquidity provision schemes granted to prequalified countries.

Such a system is necessary in a world of deep financial integration with private financial institutions, not only states, needing access to liquidity and with regional spillovers, especially in currency unions, justifying mobilising resources from neighbours and partners. As things stand, however, this network does not constitute a coherent system, in terms of coverage, resources, capabilities, predictability. It is questionable whether it will evolve into a coherent system, or degenerate into fragmentation.

5. **Within the GFSN, coordination problems are being addressed pragmatically, but difficult issues remain unsolved.** Coordinating them raises issues of:

   - *Availability*. Commercial, political or geopolitical considerations weigh on the choice of countries to which liquidity lines are being provided by major central banks;
   - *Conditionality*. Even if institutions share the same philosophy the aims, maturity and scope of loans may differ, and so will the associated conditionality;
   - *Terms of lending*. Whereas Fund lending conditions are broadly uniform across countries, bilateral or regional lenders may tailor theirs to programme countries;
   - *Debt relief*. Multilateral debt relief granted to insolvent borrowers is in principle based on objective criteria and broadly uniform across countries; this is less true for bilateral or regional lenders, which may be based on economic or strategic interest and even seize collateral instead of participating in a multilateral restructuring;
   - *Seniority*. The hierarchy of official creditors raises difficult issues of principle, especially when loans were provided at the same time and on the basis of tightly coordinated conditional programmes.

6. **While the central role of the IMF in the global financial architecture is generally regarded as essential, its future cannot be taken for granted.** The Fund is now part of a heterogeneous network where it is neither dominant nor indispensable. This may affect fundamental principles of the international financial architecture such as equality of treatment and transparency. More fundamentally, the IMF was part of a post-war order characterised by a monetary and financial architecture dominated by the US. Whether this can evolve into a more symmetric multipolar architecture where several currencies coexist and power is more evenly distributed is highly uncertain.

7. **Architecture issues and governance issues cannot be separated.** As the dominant veto player, the US exercises overwhelming influence over the IMF but is not willing to increase its resources significantly. China, India and other emerging countries are unlikely to invest much into the future of the institution as long as they feel massively underrepresented in its governance. Europe is a staunch supporter of the Fund but is unwilling to renounce the influence that it currently enjoys within it. Unless addressed as a matter of urgency, this configuration portends the risks of a persistent deadlock in the reform of the international financial architecture and of its eventual fragmentation.