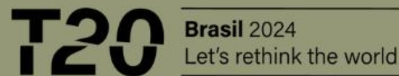
T20 Policy Brief



Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

How To Build a More Equitable and Inclusive Global Financial Safety Net?

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Abstract

The frequent breakouts of international financial crises require the establishment of a global financial safety net. The current global financial safety net includes the IMF, regional financing arrangements, bilateral swap agreements, and foreign exchange reserves of various countries. After the burst of the global financial crisis and COVID-19 pandemic, the current safety net faces the threat of fragmentation. To meet the numerous challenges ahead, we propose to build a more equitable and inclusive global financial safety net designated to provide financial assistance for countries in need. Our policy suggestions include: (1) boosting the reform of the IMF's funding sources and quotas, and consolidating the IMF's pivot position in the global financial safety net. (2) broadening the coverage and enhancing the role of regional financial arrangements. (3) using the IMF as a platform to strengthen collaboration between different levels. (4) preventing new risks generated by new (sovereign) digital currencies.

The Challenge

With global economic uncertainties rising and international financial crises breaking out frequently, it is of great significance to strengthen the Global Financial Safety Net (GFSN). The current GFSN includes four parts: the first is foreign exchange reserves at the national level; the second is bilateral swap agreements (BSAs) between countries; the third is regional financing agreements (RFAs); and the fourth is the IMF at the multilateral level.

The current GFSN is more fragmented than in the past, and individual countries and regions have access to different sizes and types of financial assistance (Denbee et al 2016). The current GFSN cannot guarantee the stability of the global financial system, nor can it cope with systemic financial risks, especially after the experiences of the global financial crisis and the COVID-19 epidemic. The current GFSN is more of a suboptimal patchwork than a systematic design (Shafik, 2015), and its structure is facing the following five challenges.

First, accumulating foreign exchange reserves is inefficient, and the risk of being sanctioned by powerful countries like the US is gradually rising. Nonetheless, individual countries' foreign exchange reserves remain the largest component of the GFSN.

However, reserve accumulation brings several problems. First, the cost of holding reserves is high, and the return from it is low. Most of reserve assets are low-yield, low-risk foreign government bonds, and they are exposed to both valuation and foreign exchange risks. For example, from 2022 to 2023, the Federal Reserve raised interest rates 13 times in a row, causing a sharp price decline in U.S. Treasury bonds. Emerging market countries (EMEs), which invest a large proportion of foreign exchange reserves in U.S. Treasury bonds, suffered large valuation losses. Second, foreign exchange reserves are

distributed very unevenly across different regions. Moreover, on some occasions, even those countries with abundant reserves are reluctant to use them to intervene in the foreign exchange market. For example, during the global financial crisis, nine of the largest emerging market economies refrained entirely from using their reserves (Shafik, 2015). The major reason was that those economies deemed foreign exchange reserves as the most important self-insurance tool, and they were reluctant to use these reserves unless absolutely compelled. Third, the risk of sanction has increased. After the outbreak of the Russia-Ukraine conflict, the United States has frozen the Russian Central Bank's foreign reserve assets. After that, other EMEs began to worry about the safety of their own overseas assets. As a result, EMEs have begun to reduce their investments in U.S. Treasury bonds and increase their holdings of gold.

Second, the Federal Reserve swap lines may occupy the core position of the GFSN, replacing the IMF and other regional financial arrangements. During the US subprime crisis and European sovereign debt crisis, the Fed conveyed dollars through bilateral US dollar swaps in order to alleviate funding liquidity shortages in the offshore dollar market. These new established bilateral Federal Reserve swap lines provided timely liquidity support, helping stabilize global financial markets and cross-border capital flows, avoiding a full-blown dollar funding crisis. We had a similar story during the 2020 pandemic. These episodes highlighted the importance of an international lender of last resort (Carstens, 2021). However, only a few countries benefited from these swap lines (McCauley and Schenk, 2020). Fed currency swaps are exclusive, affecting only developed countries with close economic, trade, financial and military relations to the US, like the ECB, Bank of England, Bank of Japan and Bank of Canada. Among the EMEs, only Brazil and Mexico had the opportunity to establish a currency swap agreement with the United States. Major EMEs such as China and India cannot participate

in it (Zhang and Chen, 2023), which is problematic. Although the European Central Bank (ECB) and the People's Bank of China are also establishing currency swaps, they are not as effective as the Fed currency swap in solving liquidity shortages. For example, after the outbreak of the European debt crisis, a large amount of funds flowed from financially fragile member states to relatively stable member states. The balance of payments of each member state became seriously polarized. Commercial banks had to turn to their national central banks to make up for the gap in cross-border fund settlement. This resulted in a rapid expansion of imbalances in the ECB's clearing system. Although, it is also true that Target 2 helped to contain the crisis. Thus, in the future, we need a resilient global financial safety net that does not rely solely on the Federal Reserve (Carstens, 2021).

Third, Regional financing arrangements lack the ability to conduct a sound and comprehensive macro-economic and macro-prudential supervision. The occurrence of major international financial crises always prompts the establishment and development of RFAs. However, once the crisis has passed, the development of these RFAs slows down. Compared with the European Stability Mechanism, the Chiang Mai Initiative Multilateralisation (CMIM) process faces the following problems. First, the CMIM's funding is insufficient, and its operation efficiency is low. Moreover, the CMIM loan mainly focuses on short-term financing needs, and the loan maturity is relatively short (Asian Development Bank, 2019). Second, limited by the insufficient supervision capacity and in order to avoid moral hazard, the CMIM requires that when the financing exceeds a certain proportion, the borrowing country must abide by the IMF loan conditionalities. Third, due to the distrust between countries in the region, it is difficult to develop a truly sufficient and independent regional financial safety network (Gao et al 2024).

Fourth, The IMF faces serious problems in the fields of funding scale, resource composition, and quota allocation, which weaken its core position in the current GFSN. (1) The IMF’s current loan capacity is insufficient to deal with global systemic financial crises. (2) The proportion of IMF quota-based permanent funding to overall funding is too low. In other words, IMF loans rely heavily on temporary funding sources, which will hurt the IMF’s legitimacy in the long run. (3) The current status and power of emerging markets and developing countries are not fully reflected in the IMF governance structure. The voting power of the IMF depends on the quota of the member states, and the quotas of some large emerging markets and developing countries are significantly unrepresented (Gao, 2023). (4)The IMF’s loan conditional policies are relatively stringent. In 2009, IMF Board approved a major overhaul to the Fund’s lending framework by modernizing IMF conditionality, introducing a new flexible credit line, enhancing the flexibility of the Fund’s regular stand-by lending arrangement, doubling access limits, adapting and simplifying cost and maturity structures for its lending, and eliminating facilities that were seldom used. However, conditionality policies still limit the loan availability of borrowing countries.

Fifth, Central Bank Digital Currencies (CBDCs) could bring unprecedented risks to the GFSN. Without appropriate safeguards, especially for countries with open capital accounts, capital flows facilitated by CBDC may lead to an increasing demand for GFSN resources by introducing new shocks or amplifying existing shocks via currency substitution, exchange rate depreciation, and bank runs. In turn, this new phenomenon could instigate policymakers to expand the GFSN as a way to mitigate shocks. Finally, even if it is improved, the GFSN may increase in size but become more uneven and fragmented (Kim et al, 2024).

The G20's Role

The G20 plays a key role in promoting political consensus among the world's largest economies and should be committed to consolidating the G20's core role in global financial governance. Members of the G20 hold 81% of the IMF's quotas and 78% of its voting rights. Since the global financial crisis in 2008, the G20 has played an active role in promoting IMF quota reform (Gao, 2023).

The "G20 New Delhi Leaders' Declaration" issued at the G20 Summit in September 2023 reiterated the importance of establishing a strong, quota-based and adequately resourced IMF. In future reforms, the G20 will continue to guide the agenda of IMF quota reform. The G20 welcomes discussions on the potential macro-financial implications arising from the introduction and adoption of Central Bank Digital Currencies (CBDCs), notably on cross-border payments as well as on the international monetary and financial system (G20, 2023).

The G20 should provide a cooperation platform for promoting the cooperation of global financial security networks at different levels. Driven by the G20, global macroeconomic policy cooperation has gradually strengthened. The G20 Finance Ministers and the Presidents of the Central Banks, and the G20 summit are gradually routine and mechanized. The G20 is routinely promoting the reform of institutions dominated by the IMF. For some time to come, the G20 should be committed to leading the global financial governance reform along the right track. For this, the G20 should continue to promote the reform of international financial institutions and build a more equitable and inclusive GFSN to avoid the risks of fragmentation.

Recommendation to the G20

In order to build a more equitable and inclusive GFSN, the coordination among the global standard-setting bodies, regulators, central banks, and multilateral and relevant private-sector institutions will be critical (Kim et al, 2024). To achieve this, certain actions are necessary:

1. Promoting IMF reform.

The G20 should be committed to promoting the IMF as the core of the global financial safety net and playing the key role in responding to international financial crisis. First, the G20 should encourage the IMF to increase capital, reform quotas, issue more special drawing rights and expand the scope of its use. Second, the G20 should continue to increase the proportion of officials and scholars from EMEs who serve as senior officials of the IMF, so that it can more fully reflect the voices and demands of EMEs (Chen and Zhang, 2021). Third, the G20 should encourage the IMF to direct debt restructuring and relief initiatives aimed at building a broader sovereign debt restructuring system, and to reform the emergency financing mechanism from a procyclical to countercyclical based arrangement (Gallagher and Gao, 2021). As proposed by Alfaro et al (2024), it should also consider the establishment of an Emerging Markets Fund (EMF), inspired by the ECBs Transmission Protection Mechanism, and able to provide liquidity in systemic crises. Fourth, the G20 should encourage the IMF to reform loan conditionality policies and even in exceptional cases, unconditional loans should be provided, so that more countries can receive assistance.

2. Strengthening and improving regional monetary cooperation arrangements

In Asia, the G20 should continue to promote the CMIM reform in order to improve its practicability and effectiveness. In order to make up for the gap between the supply and demand of regional liquidity funds, enhance the level of regional financial integration, and improve the multi-level global financial safety net, it is necessary for CMIM to be upgraded from the current stage to a regional monetary fund. However, the construction of a regional monetary fund needs to follow a certain path. Based on the following criteria: the measurement of the fund's scale, the design of loan instruments, the institutional construction of governance and economic surveillance functions, and the exploration of higher-level regional monetary cooperation are the keys to determining the feasibility of regional monetary funds (Gao et al, 2024). Thus, other RFAs should carry similar reforms. In this way, the G20 could create a strong and more reliable global financial safety net by stitching together its fragmented regional networks (G20, 2018). In addition, the G20 should be committed to promoting the collaboration of currency swap networks at different levels.

3. Guard against new risks brought by CBDCs.

In an increasingly digital world, it is important to improve the coordination role of the G20 among all layers of the GFSN to maximize its efficiency. At the national level, a potential shift to a multipolar reserve configuration may require global reserve currency issuers to substantially expand liquidity backstopping mechanisms to minimize the risk of disorderly switching between reserve currencies and improve access to GFSN resources. At the same time, countries with open capital accounts should pay more attention to the potential capital flow risks brought by digital currencies. At the bilateral and regional level, we should expand BSAs and RFAs to areas outside the digital currency

block and upgrade them into preventive tools to guard against new risks posed by CBDCs and other digital currencies like crypto and stable coins. At the multilateral level, we should promote the IMF's financial sector to assess potential risks arising from DM. Efforts will be needed to develop DM taxonomies, monitor trends, identify key risks, and give advice on design issues to mitigate risks, as well as to provide a platform for global dialogue and cooperation (Otero-Iglesias et al, 2023). The IMF should help countries with weak capacity to avoid a digital divide and ensure that new solutions work for all countries (Kim et al, 2024). In a more DM-driven world, the G20 should urge the IMF to reassess its size and lending toolkit to ensure that the Fund has adequate resources to provide its member states with enough financial assistance.

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