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Abstract: The recent global crisis has demonstrated strongly that a systemic crisis victimizes a large number of innocent crisis "bystanders." In order to prevent global crisis recurrence, and avoid victimization of such innocent crisis bystanders, the global financial safety net needs to be substantially strengthened. In this regard, assigning greater roles to central banks in addressing systemic crises seems one noteworthy option having several significant advantages.

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Introduction

The global financial crisis of 2008-09, the first truly "global" crisis in the postwar era, has become a catalyst for the reform of global economic governance, as well as that of the international monetary and financial systems, and elevated the Group of Twenty (G20) to the position of premier forum for global economic governance. The rise of the G20 as the center of world economic management has been a historic event in the world political economy, ending the traditional "club model" of global economic governance led by a handful of advanced economies—namely, the Group of Eight—by finally allowing emerging economies a place at the head table of global economic management. This significant change in global economic governance has brought about expectation that the interests of emerging economies, which account already for roughly half of world gross domestic product, will now be better reflected in world economic management.

Disappointingly, however, the on-going process of reform of the international monetary system under G20 auspices has fallen short of this expectation. For emerging as well as developing economies, one of the most urgent reform tasks is strengthening the global financial safety net (GFSN), the set of mechanisms for providing financial assistance to deal with short-term liquidity shortages. Only very limited progress has been made on this task so far, however, even though it has been on the official G20 agenda since the 2010 Seoul Summit.

Crisis bystanders

Today's global economy is more integrated and interconnected than ever. And this great unification of the global economy has on the one hand provided significant economic benefits. On the other hand, however, it has also amplified the risk of systemic crisis, particularly by greatly increasing the size and volatility of cross-border capital flows. As a result, a localized shock can now be very easily transformed into a global one.

The increased systemic risk in the global economy and its detrimental effects were powerfully illuminated by the recent global crisis. While originating from advanced economies, particularly the United States, the crisis nevertheless spread rapidly throughout the world after the collapse of Lehman Brothers in September 2008. As risk aversion surged and international investors repatriated funds to their home countries, a number of emerging and developing economies suffered from sudden stops and substantial capital flow reversals, as capital ironically flew back to the economies where the crisis originated. Of particular interest, those economies most integrated into the global economy suffered the greatest damage.

One point deserving special attention in this regard is that a large number of the emerging and developing economies hurt in this process were innocent crisis "bystanders." They had maintained sound domestic policy frameworks and economic fundamentals, but were still caught up in the crisis—due largely to foreign currency liquidity shortages. A recent study (Bi and Lanau 2011) by the International Monetary Fund (IMF) finds more than twenty emerging economies to have been such crisis bystanders victimized by the crisis.

Systemic crises are very virulent, damaging innocent economies irrespective of their fundamentals by triggering panics and chain reactions across markets. Emerging and developing economies are highly vulnerable to sudden stops and large capital flow reversals, as they do not issue fully convertible "hard" currencies and must thus borrow in foreign currencies. In other words, they lack "lenders of last resort" to address foreign exchange liquidity problems. And at the center of the problems in most emerging and developing economies during the crisis was, indeed, a shortage of dollar liquidity.

The international monetary system is for the foreseeable future very likely to remain based on reserve currencies issued by sovereign states, although the number of national reserve currencies could perhaps increase by one or two. The risk will thus persist of outbreaks of systemic shock hurting innocent crisis bystanders with strong fundamentals but lacking short-term foreign currency liquidity. Strengthening of the GFSN is therefore an urgent task for the world economy. To prevent localized shocks from evolving into full-blown systemic crises and victimizing innocent crisis bystanders, the GFSN should be enhanced with capacity for exercise of an international lender of last resort function, to effectively address short-term foreign exchange liquidity needs during times of systemic crisis.

Costs of excessive reliance on reserves

The current absence of such an effective GFSN has led most emerging and developing economies to rely heavily on the self-insurance mechanism of foreign exchange reserve accumulation. The global crisis may in fact have provided them incentive for building up more reserves, given the great benefits of reserve accumulation such as their immediate availability and the lack of stigma effects attached to their use. Reserve accumulation also entails substantial costs, however—to both individual economies and to the global economy as a whole. At the domestic level, holding of reserves generates carry costs, as the returns on the foreign assets the reserves are held in tend to be below the interest rate on domestic assets; opportunity costs, as a large part of the national wealth finances developed country debt rather than being invested in domestic activities having higher returns; the transaction costs of maintaining a large asset portfolio; and sterilization costs, if sterilization reaches a high level and its effectiveness declines. At the global level, excessive reserve accumulation associated with the large global imbalances is also a potential source of global financial instability.

In addition, and more fundamentally, the validity of reserves as a buffer against a liquidity shock has come under question since the global crisis, given their quite limited actual use at that time. During the crisis, in fact, markets showed a tendency to respond more sensitively to declines in reserves than to the absolute reserve levels, thus constraining reserve use (Aizenman 2009). Moreover, it is indicated that the effect of reserves as a buffer declines rapidly after their size reaches a certain point, suggesting their limitations as a crisis prevention instrument (GFSNEG 2010). Ultimately, therefore, the recent global crisis demonstrated quite clearly that strong domestic fundamentals and foreign exchange reserves are insufficient for protecting emerging and developing economies from sudden detrimental external shocks.

Principles for strengthening of the GFSN

It is thus apparent that, without any strengthening of the GFSN, the vulnerability of emerging and developing countries to systemic crisis will persist. The critical question will then be how to strengthen it. Most fundamentally, in order for the GFSN to be effective it must be designed in a way that increases its substitutability for foreign exchange reserves. In order for the GFSN to be actually used by emerging and developing countries, they should perceive it to be equally as reliable as holding reserves on their own. And for this purpose the GFSN should be designed to satisfy three requirements: sufficiency, certainty, and attenuation of stigma.

Firstly, to ensure market confidence, GFSN resources should be sufficient for coping with the magnitude of a systemic crisis. This ultimately implies in practice that an international lender of last resort function should be in place. Secondly, the certainty of GFSN accessibility must be great, although accessibility per se should not be high. High certainty of access may be obtained through the establishment of transparent ex ante criteria for determining access eligibility. Finally, the GFSN should have minimal stigma, both market and political, associated with its use.[1] For this, the "first mover problem" (of countries' reluctance to seek external support due to fears of stigma) must be resolved. This may be achieved by designing the GFSN so that unilateral offers of support are made prior to requests for it, publicly and simultaneously to multiple countries meeting the ex ante access eligibility standards and facing short-term liquidity problems. The ex ante access eligibility standards should be tight, and ex post conditionality eliminated, thus helping to weaken stigma by demonstrating the crisis to be the result of bad luck rather than the countries' own intrinsic problems.

Of course, as is widely indicated, increased sufficiency and certainty together with lack of ex post conditionality may create moral hazard. Yet moral hazard can be mitigated to a significant degree by careful design of the GFSN. Most of all, insofar as financial assistance is provided only to innocent crisis bystanders in need of short-term liquidity support, the GFSN is unlikely to lead to moral hazard on the parts of the recipient economies. In this respect, it is particularly necessary to establish a workable ex ante definition of innocent crisis bystanders, by adopting certain appropriate indicators—for instance, terms of trade—as measures of "exogenous shock."[2] It is also important to set up tight and transparent ex ante eligibility criteria for access to the GFSN, and to conduct strong and regular monitoring and surveillance. And limiting the period of assistance provision to a short time, with the main goal of addressing short-term liquidity problems, will also likely help reduce moral hazard.

Such strengthening of the GFSN is in addition unlikely to exacerbate moral hazard on the part of private investors, given that the financial assistance is offered to recipient governments, which maintain discretion in their distributions of it to their private sectors. In other words, "constructive ambiguity" toward private investors is to a significant extent always maintained at the domestic level. Furthermore, it should be remembered that in practice every country offers a lender of last resort function domestically, despite the potential moral hazard problem, simply because the related benefits overwhelm the costs. And at the global level, the benefits from an effective GFSN are also likely to greatly exceed its costs.

Limitations of existing system

There is of course a form of GFSN in operation at present. The IMF has been at the forefront, adopting a set of new crisis prevention and resolution instruments since outbreak of the global crisis. It has established a Flexible Credit Line (FCL) without ex post conditionality, for economies having robust policy frameworks and strong fundamentals. It also introduced a

[1] Market stigma refers to the fear that markets will respond adversely to a country that accesses the GFSN, while political stigma indicates the fear of negative political consequences of GFSN use.
[2] We owe this point to Joshua Aizenman.

Precautionary Credit Line (PCL) with limited ex post conditionality, for countries with moderate vulnerabilities, and has recently since the 2011 G20 Cannes Summit replaced this with a new lending facility, the Precautionary and Liquidity Line (PLL). The eligibility criteria for PLL access remain the same as under the PCL, but the PLL is more flexible in terms of balance of payments need and arrangement duration.

These facilities have not been as effective as expected, however, owing to several significant problems. Most of all, they are inadequate for dealing with a systemic crisis proactively. Access to the new lending facilities remains determined on a case-by-case basis instead of via unilateral offers to multiple economies, and their use is as a result not free from stigma. And emerging and developing countries have indeed hesitated to use them. To date, only three—Colombia, Mexico, and Poland—have used the FCL, and only one—Macedonia—the PCL. Many economies in fact sought other channels during the crisis, when available.

Among alternatives to the IMF facilities, the swap lines of the US Federal Reserve in particular were critical during the global crisis. The Fed provided temporary swap lines to ten advanced and four emerging economies, even in unlimited amounts for some advanced economies, thereby acting as global lender of last resort for the dollar just as it has played its traditional lender of last resort role in its domestic markets. Such currency swaps between central banks are currently executed on an ad hoc basis, however, with the swap recipients being decided at the discretion of the issuing central bank. A study by Aizenman and Pasricha (2010), of the Fed's swap lines during the crisis, found that the swap counterpart countries were in fact those having strong financial and trade ties with the United States. This ad hoc nature of the current swap system lowers the certainty of access to such central bank swap lines, impeding their effectiveness as a GFSN. There is in addition a possibility that the operation of such ad hoc bilateral financial assistance may be affected by the assistance providing state's foreign policy goals, other than global economic stability, which will also hinder its functioning as an effective GFSN.

It is thus clear that the GFSN needs improvement, based upon the principles articulated above, if it is to be actually and effectively used by emerging and developing economies. An important question that then follows in this regard is who should take the central position in a reformed GFSN. One strong candidate is certainly the IMF, which has led the reform of the GFSN so far. And the IMF has in fact been discussing introduction of a facility to unilaterally offer short-term liquidity assistance to systemically important economies having strong fundamentals—under the proposed titles of, firstly, Multicountry Swap Lines, and secondly the Global Stabilization Mechanism. There has been strong discord on this between advanced economies and emerging and developing economies, however, leading to IMF failure to adopt such a system. It is also doubtful whether the IMF can be assured of sufficient resources to provide assistance to multiple economies during a systemic crisis. During the Cannes Summit, G20 leaders in fact failed to agree on specific measures for boosting the IMF's resources, although agreeing in principle to do so.

It is also quite questionable whether any IMF facility can be free from stigma, particularly of a political nature, given the persistent strong negative connotations attached to the IMF. Such adverse IMF-related connotations might weaken should its governance structure change, to strengthen its legitimacy by more appropriately reflecting emerging and developing economy voices. But such change is difficult to realize given the United States' and Western European economies' reluctance to reduce their voting shares. Advanced economies including the United States have in in fact recently rejected proposals by emerging economies to improve the IMF's firepower for dealing with the eurozone crisis—due partly, it is suspected, to their concerns that these proposals would increase emerging economies' influence in global economic governance.

There are regional financial safety nets as well, of course, such as the Chiang Mai Initiative in Asia and the European Financial Stability Mechanism in Europe. And it is sometimes indicated that financial support through regional facilities has the advantage of reduced stigma. The resources of these facilities are not large enough to effectively address a systemic crisis, however, especially should most countries in the region concerned be hit by crisis at the same time. Use of regional facilities is in practice also associated with the IMF to a large extent, giving rise to the same concerns about IMF-related stigma just mentioned. And indeed, the Chiang Mai Initiative has until now never been called upon, even during the global crisis.

Need for greater roles of central banks

Given the limitations of the IMF and regional facilities in taking the central role in a reformed GFSN, one alternative worth consideration is assigning greater roles to central banks. This scheme has the significant advantage of meeting the condition of sufficiency, given central banks' money issuing power. Especially, central banks issuing reserve currencies could serve as true international lenders of last resort to address foreign exchange liquidity shortages at the global level. There would also likely be less stigma attached to central bank financial support, as in the case of the Fed's swap lines during the global crisis, since support is usually provided through technical instruments like currency swaps. For a similar reason, expansion of the roles of central banks would likely also have an important political advantage, in that domestic opposition in the assistance-providing nations might not be strong. There was indeed no great domestic opposition to the Fed's swaps during the global crisis. Give such advantages of expanding central banks' roles, it is encouraging that at the Cannes Summit G20 leaders came to officially recognize that "central banks play a major role in addressing liquidity shocks at a global and regional level," although they did not come up with specific measures to strengthen this role (G20 2011).

As discussed earlier, the current system of central bank swaps has the significant problem of high uncertainty, a problem that must be tackled to improve GFSN effectiveness. One option to consider in this regard may be to institutionalize central bank swaps on a standing basis, for instance by providing the Bank for International Settlements (BIS), the core intergovernmental organization of central banks, access to credit lines with individual central banks. The Federal Reserve in fact established standing swap lines with foreign central banks in the early 1960s, under the Bretton Woods system, to help maintain international monetary stability, and maintained them until the late 1990s. Meanwhile, use of the BIS rather than the IMF would have the advantage of lowering central banks' concerns about monetary policy independence, given their resistance to linkage between their own monetary operations and those of the finance ministry-centered IMF.

It is true that reserve currency-issuing central banks, including the Fed and the European Central Bank, are currently opposed to establishing any permanent arrangements for their swap lines, emphasizing that "constructive ambiguity" is necessary to minimize moral hazard. As discussed earlier, however, moral hazard on the part of recipient governments can likely be significantly reduced by careful GFSN design, while "constructive ambiguity" toward private institutions can always be maintained to some extent as central banks hold discretion in distributing the foreign exchange liquidity received from these swaps in their domestic markets.

Finally, although their effectiveness as a GFSN may be less than that of standing swap lines, some other options may deserve attention as well. As one example, it may be worth considering cross-border collateral arrangements, under which central banks agree to provide liquidity to cross-border financial institutions in their own jurisdictions, against collateral assets held by foreign central banks. Central bank repo transactions, in which a central bank provides liquidity in its own currency to another central bank through short-term liquidity agreements, against the foreign reserve assets of the recipient central bank as collateral, may also merit discussion.

For a more responsible system

If the suggestions proposed herein are to be followed, there are surely many practical, technical and operational problems and complexities to overcome. Yet, as decades of theoretical and empirical work in political economy suggest, most such problems can be resolved if there is strong international political will to do so. And in this regard, what is most necessary for strengthening of the GFSN is the support of advanced economies, particularly those that issue the reserve currencies.

Unfortunately, however, as mentioned earlier, advanced economies have been opposed to establishment of a strong GFSN with the ability to cope with systemic crisis. As regards the GFSN, their interests seem to differ from those of emerging and developing economies, perhaps since they are less likely to face foreign exchange liquidity shortages, and also because they may perceive a need for bearing asymmetric burdens in serving as the GFSN's major credit suppliers.

Yet strengthening of the GFSN will clearly benefit advanced economies as well as emerging and developing economies. Firstly, it will contribute to rebalancing of the global imbalances, by helping to ameliorate emerging and developing economies' incentives for building up "excessive" reserves, and in turn increase international monetary system stability; as is widely pointed out, continuation of the current huge level of global imbalances could cause future global crisis recurrence. In addition, any spread of crisis from advanced to emerging and developing economies will lead to the former encountering secondary shocks from the latter, through the financial and trade linkages among them. Moreover, given that their own reserves alone cannot be sufficient tools for securing monetary and financial stability, the persistent lack of a system for reliable external assistance could eventually lead emerging and developing economies to seek shelter from volatile capital flows by more direct management of them. Indeed, a growing number of small open emerging economies have since the global crisis begun to adopt macroprudential regulations aimed at addressing capital flow volatility. Yet excessive pursuit of such policy may harm both emerging and advanced economies, by limiting the benefits to them from financial openness.

It should be emphasized as well that strengthening of the GFSN aims principally to protect innocent crisis bystanders, and that global shocks are more likely to originate from advanced than from emerging or developing economies, as seen during the recent global crisis. In other words, the GFSN is in principal intended to protect innocent emerging and developing economies from shocks caused by advanced economies. And in this respect it would seem fair for the main culprit to help its innocent victims.

It is frequently stated that world economic problems stem from the inherent conflict between global markets and national states. And it is certainly true that we do not have any global authority that governs or manages the global markets. Such lack of a global authority can be to some extent made up for, however, by international cooperation. Global markets require effective global economic governance. Emerging economies' contributions to the world economy have been growing rapidly in recent years, and when advanced economies struggle to recover from recession it is emerging economies that are likely to serve as the locomotives of world growth. For the sake of the world economy as a whole, therefore, a safeguard should be in place that can protect these economies from hazardous external shocks. And this in conclusion requires international cooperation between advanced and emerging and developing economies.

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