Benoît Cœuré: Unexpected events and the global safety net

Remarks by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the IMF-SNB High-Level Conference on the International Monetary System, Zurich, 8 May 2012.

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Madam Managing Director, Mr Chairman of the Governing Board, ladies and gentlemen,

I am honoured to speak at this third IMF-SNB high-level conference on the International Monetary System.

The recent global financial crisis, including the ongoing euro area sovereign debt crisis, has reemphasised the need for global and coordinated safety nets. Following a decade that was largely free of crises, in the aftermath of Lehman Brothers collapse, liquidity has dried up globally and the crisis has spread to, and within, the euro area.

The view that crisis resolution mechanisms were inadequate also prevailed during the Asian crisis of the 1990s. This is one of the reasons why many emerging market economies have built up national foreign exchange reserves.

1. Recent innovations to global financial safety nets

The recent crisis has led to substantial progress in the global safety net, including the following improvements.

- The strengthening of the IMF's crisis prevention toolkit through a combination of increased firepower and more flexible and effective instruments: an increase in IMF resources through bilateral loans in 2009; an expanded New Arrangements to Borrow in 2011; an increase in IMF resources in 2012 (during the last Spring Meetings firm commitments were made to increase the resources made available to the IMF by over USD 430 billion, in addition to the quota increase under the 2010 reform); the introduction of the Flexible Credit Line and Precautionary Credit Line (the latter has more recently been replaced by the Precautionary and Liquidity Line, as recommended by G-20 Leaders in Cannes); and an agreement to double the amount of IMF quotas, thereby in effect doubling the Fund's permanent resource base.
- The creation and strengthening of the European financial safety nets: the European Financial Stability Facility and, more recently, the European Stability Mechanism. The overall European firewall, including the amounts already committed under the Greek Loan Facility and the European Financial Stability Mechanism amounts to approximately EUR 800 billion, more than USD 1 trillion, which is being mobilised to ensure the financial stability of the euro area.
- Also, at a regional level outside Europe, progress is ongoing in Asia towards strengthening the Asian financial safety net, known as the Chiang Mai Initiative Multilateralisation (CMIM), with the doubling of the CMIM fund to USD 240 billion.

In parallel, important steps have been taken to mitigate the spreading of risks *within* a highly interconnected global financial system, making it more resilient to unexpected events:

- Systemically important financial institutions, which contribute to the spreading of risks given their high level of interconnectedness, will be subject to stricter capital requirements under the Basel III agreement;
- Financial infrastructures have been made more resilient. First, the Financial Stability Board is working on safeguards aimed at promoting global clearing in order to facilitate access to, and the use of, global clearing houses. Second, regulators and overseers have just finalised a new set of regulatory principles for financial market infrastructures aimed at ensuring that any such infrastructures, whether domestic or global, will be better able to withstand shocks and unforeseen events. Moreover, regulators and overseers are required to adopt regimes for effective cooperation with each other.

2. Further improvements to global financial stability nets

While all these measures have undoubtedly made an important contribution to stabilising the global economy, many observers have argued that gaps remain in the current global financial safety nets. Existing mechanisms for dealing with crises have been seen as being deficient in three respects: (i) insufficient amount of financial fire-power; (ii) insufficiently flexible or fast decision-making and (iii) insufficient coordination with respect to both financing and surveillance.

These deficiencies have been seen as leading countries to increase their foreign exchange reserve holdings. For the holders, the great attraction of reserves is that they provide instantaneous and unconditional liquidity. However, the accumulation of a large stock of reserves is not only based on precautionary motives. Moreover, even at the level of the individual holder, there are downsides as reserves come with a quasi-fiscal cost.[1]

How can we go forward and what can be done differently? Overall, there is widespread agreement about what a global mechanism should do: (i) reduce the demand for self-insurance through reserves accumulation; (ii) provide fast-disbursing financial assistance in large amounts to the "innocent bystanders"; and (iii) reduce global imbalances.[2]

However, it is clear that any further improvement will need to strike the right balance between, on the one hand, efficiently addressing global liquidity shocks and, on the other, avoiding moral hazard and respecting the mandate of individual institutions.

During the financial crisis, swap lines among major central banks played a pivotal role in easing the funding pressure of banks. Empirical evidence and anecdotal feedback suggest that market participants see them as a useful safety net, also in times of limited usage.

While swap agreements have so far been set up with a high level of urgency, it is worth considering a framework of permanent stand-by swap lines. There are important limitations, however. Such a framework should not constrain the monetary policy and operational frameworks of participating central banks.

Even more importantly, the establishment of global financial safety nets should not lead countries, or financial institutions, to engage in overly risky strategies.

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[1] See Obstfeld, M. "The International Monetary System: Living with Asymmetry", November 2011, http://www.nber.org/chapters/c12596.pdf

[2] See Pickford, S. "Global financial safety net". Chatham House International Economics Brief. IE BP 2011/02.

3. Reaping the full benefits of international financial integration

At a deeper level, global financial safety nets cannot be a substitute for a more resilient and better functioning global financial system. Let me mention a few avenues for reflection.

First, the global financial system should adapt to an increasingly multi-polar international monetary system. Various initiatives have been taken by Chinese authorities to promote the renminbi's international role. Its use by market participants has already increased, particularly as a currency for international trade invoicing and, more recently, as a currency for international issuance, deposit and selected official investments. Such initiatives should be increasingly reflected in market infrastructures.

Second, global financial safety nets are temporary instruments – and as we all know, temporary measures often risk becoming permanent. Measures aimed at addressing liquidity crises should not weaken policymakers and market participants' incentives to address financial market malfunctioning in a more durable manner. Let me give an example: in the euro area, the ECB has extended liquidity to banks faced with temporary funding difficulties, provided they are financially sound and can post adequate collateral, but the ECB should not act as a substitute to euro area capital markets on a durable basis. This is all the more important as shocks to cross-border capital flows, such as sudden stops in capital movements, have proven to be persistent rather than short-lived. More analytical reflection on what has made such shocks persistent, and how this can be addressed at a deeper structural level would therefore be welcome. Today, there are many signs that political support for international financial integration has weakened in domestic constituencies, and we are witnessing an increased fragmentation of capital markets at a global and at a regional level[3]. This should not be accepted, because we would then lose the benefits of financial integration. Financial markets, if properly regulated, should regain a key role in allocating resources and sending price signals to individual players and policymakers.

Third, an interconnected financial system requires a very high level of harmonisation of financial regulation and cooperation among financial markets and banking supervisors, both at the international and at the regional level. In the euro area, the ECB has argued in favour of a single regime for bank resolution and, down the road, in favour of a single European institution in charge of insuring deposits and winding down failed banks. If one wishes to reap the benefits of financial integration while delivering financial stability, one must be willing to give up at least partially national autonomy in financial regulation.

Fourth, one should take into account what Maurice Obstfeld has named the fiscal dimension of international liquidity[4]: expanded international lending facilities, including an expanded IMF or a stronger European framework, cannot remain unconditionally solvent in the absence of an expanded level of fiscal backup. Global financial safety nets should be backed by sounder fiscal fundamentals in all major economic areas.

I will now conclude. Global financial safety nets have been successfully strengthened under the Korean and French G-20 presidencies, and there is room for further improvement. But measures aimed at addressing liquidity crises should remain temporary, and they should not weaken the incentives to address financial market malfunctioning in a more durable manner. Even more importantly, safety nets are there only to address unexpected events. It is the duty of policymakers to take preventive action against expected disorderly outcomes, such as those resulting from current account and fiscal imbalances.

Thank you for your attention.

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[3] See "Financial Integration in Europe", ECB, Frankfurt am Main, April 2012.

[4] See Obstfeld, M. "International Liquidity: The Fiscal Dimension", NBER WP No. 17379, September 2011.