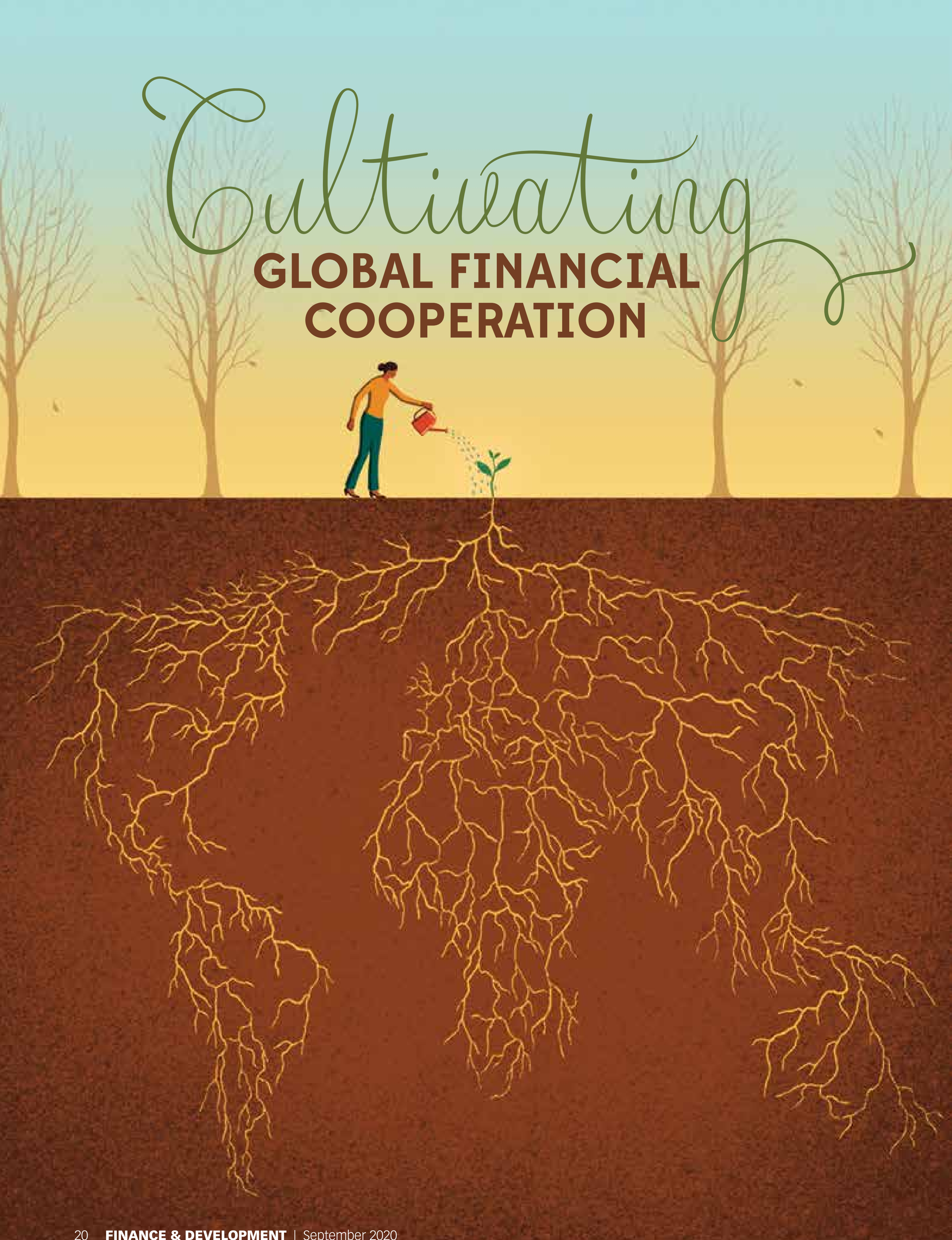
Cultivating GLOBAL FINANCIAL COOPERATION



The current crisis highlights the urgency of strengthening the global financial architecture

Barry Eichengreen

The COVID-19 pandemic is the mother of all stress tests for the global economy, and not least for emerging markets and developing economies. Early on, there were hopes that the virus might bypass low-income countries, which have fewer air-transportation links to the rest of the world, or that it could be contained in countries with past epidemic experience—in sub-Saharan Africa, for example. Such hopes were disappointed. We now know that the virus threatens all parts of the world. Moreover, even where countries have been able to avert a full-blown health crisis, the financial effects have been severe.

That financial impact preceded COVID-19's physical arrival in the developing world. Between February and April, more than $100 billion in financial capital flowed out of emerging and frontier markets, five times as much as in the first three months of the global financial crisis. The World Bank forecast that remittances would fall by an additional $100 billion in 2020, four times as much as during that earlier crisis. Global trade was forecast to fall even faster than in 2009. Commodity prices collapsed in response to the global recession, while emerging market and developing economy currencies weakened against the dollar.

This was a shock of unprecedented proportions. Governments responded with emergency spending packages in support of households and firms. Emerging market central banks cut interest rates and in some cases undertook purchases of securities. As a result, the negative impact on economies and financial systems was somewhat less than anticipated initially.

For emerging markets, this policy response was unprecedented. It was the opposite of the actions they were forced to take in earlier crises. The contrast was indicative of progress made in building fiscal space and anti-inflation credibility. One indication lies in the actions of emerging market central banks that adopted a formal inflation-targeting framework as a credibility-enhancing device. Through the first five months of 2020, those central banks were able to cut interest rates by 40 to 50 basis points more than their non-inflation-targeting counterparts.

This is not to deny the existence of financial stress. But the tidal wave of debt defaults, currency crashes, and financial system collapses some had predicted has not come to pass. At least not yet.

Dollar dominance

Having averted the worst does not mean that emerging market and developing economies averted the bad. The financial repercussions of COVID-19 pointed up remaining flaws in the global financial architecture and underscored the need to correct them.

To start, the pandemic is a reminder of how much the global economy—and emerging market economies in particular—relies on the dollar for international liquidity. The international interbank market, in which banks borrow and lend to one another, runs heavily on dollars. The dollar is involved in 85 percent of foreign exchange transactions worldwide. It is far and away the most important vehicle for trade invoicing and settlement. Bonds marketed and sold to foreign investors are disproportionately denominated in dollars.

Countries can shield themselves from sudden liquidity shortages, when banks refuse to lend, by holding dollar reserves. There has been significant movement in this direction by central banks and governments in recent decades, which is one reason there was not a more severe pandemic-induced dollar shortage and greater financial distress.

But a more important explanation for the absence of disruptive dollar scarcity is the extraordinary action of the US Federal Reserve (Fed), which leapt into the breach with dollar swaps and Treasury bond repurchase facilities for foreign central banks. The Fed purchased a wide range of fixed-income assets, flooding financial markets with liquidity and bringing credit spreads back down to precrisis levels. Investors seeking higher-yielding investments had nowhere to look but emerging markets, whose debt was one of the few fixed-income assets the Fed did not buy. This explains much of why capital flowed back to emerging markets after the initial period of strain.

While the Fed's forceful action prevented global financial markets from seizing up, it also pointed to a fly in the international financial ointment. The Fed provided swaps only to a selection of countries,

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and the selection criteria were not transparent. Nor is it obvious that there will be an equally foresightful Federal Reserve Board to do the same in a future crisis.

This has led to suggestions that the Fed, and perhaps other advanced economy central banks as well, should delegate the decision to extend swaps to an impartial arbiter, such as the IMF. Since central banks are not members of the IMF, this would be a decision for governments—which is a problem. Governments, especially the governments of countries that issue key international currencies, are not inclined to cede control of their central banks' balance sheets to the international community.

IMF and World Bank roles

This mention of the IMF points to another source of dollars for emerging market and developing economies: IMF lending facilities. The IMF moved quickly in response to the pandemic to create the Short-term Liquidity Line, a new facility for disbursing liquidity assistance, while enhancing access to existing facilities, including some that allow for lending without a full-fledged program. In the first half of 2020, it received more than 100 calls for emergency funding.

The IMF's overall lending capacity is limited to $1 trillion. This sum may not be enough to deal with the full impact of the pandemic and with whatever comes next. Shrinkage of IMF resources was averted by renegotiation of the Fund's multilateral and bilateral borrowing arrangements, including the New Arrangements to Borrow. However, efforts to augment those resources through an increase in IMF quotas have not produced results. Further, there has not been the requisite agreement of a supermajority of countries on a new allocation of Special Drawing Rights (SDRs), despite widespread calls from the official and scholarly communities. Reforming IMF governance in the context of the General Review of Quotas and enhancing the international role of the SDR are long-standing issues. The COVID-19 crisis is a reminder that these efforts are incomplete, and that their incompleteness weakens the global financial safety net.

The IMF's sister institution, the World Bank, could point to pandemic bonds as its contribution to weathering the crisis. In 2017, in response to the outbreak of Ebola in West Africa, the World Bank, with financial support from a set of advanced economy donor nations, underwrote bonds to be placed with private investors that paid out in a pandemic. Ex ante, this instrument seemed ideally suited to providing poor countries with insurance against health-related shocks.

It didn't turn out that way. The bonds now look to have been overengineered; their documentation was so complex that neither investors nor governments knew what they were getting. The stringent conditions triggering payments were satisfied only 132 days into the outbreak and after more than 2 million cases were identified worldwide. One of the variables triggering payouts was the number of cases identified and reported at the national level, and poor countries were the least able to identify and report cases. Unlike catastrophe bonds, which pay out in response to a hurricane or earthquake affecting one or a handful of countries, pandemic bonds triggered many simultaneous payouts, because the COVID-19 pandemic was global. Investors in these bonds therefore saw their stakes wiped out.

The distaste for this structure for both developing economies and investors became apparent when the World Bank abandoned plans for another pandemic-related issue this year. The notion of some form of financial insurance for pandemics is sound conceptually, but a satisfactory structure has yet to be found.

Dealing with debt

Last, there is the challenge of servicing debt when commodity prices and global trade have collapsed. Acknowledging these realities, in April 2020 the IMF provided debt service relief for an initial six months to 29 low-income countries that were previous loan recipients. In addition, Managing Director Kristalina Georgieva called on governments with bilateral loans to low-income countries and on private sector creditors to suspend repayments. Following a meeting of finance ministers and central bank governors, the Group of Twenty (G20) issued a declaration, the "G20 Action Plan," voicing support for these ideas.

These initiatives faced collective action problems, however. For official bilateral creditors, it made little sense to suspend payments if other governments failed to do likewise. In this case, the debtor would receive only limited relief, and the governments that agreed would end up footing the bill.

Since the 1950s, the official community has addressed this issue through the Paris Club, a group of creditor countries originally made up of Group of Seven governments, whose chair is a French Treasury official. Unfortunately, China, now the source of more official bilateral poor country debt covered by the G20 initiative than all other creditor countries combined, is not a member. China has agreed to match the Paris Club's debt relief terms, but it is not clear whether this commitment extends to loans by state banks and state-owned companies. It is not even clear how much poor-country governments owe to the Chinese official sector overall. All this would have been easier to sort out had China been a full-fledged member of the Paris Club, but it is not—yet another failure to update the global financial architecture to match the realities of the 21st century.

In the case of private debt, the task of setting out terms and organizing negotiations was outsourced to the Institute of International Finance (IIF), the association of institutional investors. This response had something of a fox-in-the-henhouse quality. The IIF cautioned emerging markets that seeking to restructure their debt could jeopardize market access. It warned that institutional investors were responsible to their clients, not to governments or the global community. Early efforts at renegotiating Argentine government bonds got hung up over conflicting contractual terms governing different bonds, reflecting the absence of a single standard for bond covenants. Progress was slowed by obstacles thrown in the way by holdout creditors.

There was no sense that the existing ad hoc machinery had the capacity to deal with a flood of cases. The absence of an international facility or even a standard procedure to deal with a wave of restructurings was glaring.

The agenda

What, then, have we learned about the financial architecture from the COVID-19 crisis? We have been reminded that resilience starts with institution and resource building at home. Governments possessing fiscal space have been able to put it to use. Where inflation expectations are well anchored, central banks have been able to support financial markets and the economy. A surprising number of emerging markets—surprising by the standards of past crises—have been able to implement supportive policies. This capacity reflects their success at building more robust monetary, fiscal, and financial institutions.

Experience at the international level is less heartening. Cross-border financial transactions remain dollar-based. There is reason to think that this will change, but little reason to think that it will change anytime soon. While the demand for dollars is global, the supply remains national: it depends on the policies of the Federal Reserve. There are potential alternative sources of dollars—not least the IMF, which could provide greater access through its existing programs and lending facilities if it had more resources. A new allocation of SDRs is another possibility. Unfortunately, there is as yet no consensus on how to proceed.

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Although the performance of pandemic bonds has been disappointing, the idea of using financial instruments and markets to insure against these risks is sound. Streamlining the design of such instruments and increasing the subsidy element provided by donors could make them more attractive to both governments and investors. The question is whether this would be enough.

Finally, there is the need to strengthen arrangements for dealing with debt. The structure of the Paris Club should be updated to match the realities of the 21st century. Official institutions should take a larger role in negotiations over restructuring private debt. They can set standards for such negotiations. They can encourage regulatory agencies to mandate institutional investors' adherence to those standards. Governments and regulators can require provisions in loan contracts (so-called single-limb aggregation clauses) that encourage rapid restructuring when a pandemic or other global crisis hits. They can prohibit trading of bonds that lack these provisions. This strategy just might work. If it doesn't, then calls for a more heavy-handed approach, involving some kind of international bankruptcy court for sovereigns, will be back. FD

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