

Avoiding the next liquidity crunch: how the G20 must support monetary cooperation to increase resilience to crisis

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Who will be the lender of last resort in the next financial crisis? Seven years and nine G20 summits on from the 2008 crisis, we still do not know the answer to this critical question. In the current institutional context, the best hope for more effective international cooperation on this question lies in reforming the International Monetary Fund (IMF)'s SDR (Special Drawing Rights) Department. Yet political challenges have impeded such reforms.

Therefore, a second-best option is to replicate the institutional design of the SDR Department in an alternative institution. The main political goal is to establish a truly multilateral hub for facilitating currency swaps. The Group of 20 (G20) has the capability and legitimacy to drive forward this reform agenda, but of late attention has waned. The G20 must urgently refocus its energy on monetary and financial policy coordination, before the next crisis hits.

This policy brief sets out clear recommendations for what reforms are needed to create a monetary system to respond to a global liquidity crisis, and explains why the G20 is the key actor to deliver this progress. During the current Turkish and the next Chinese presidencies of the G20, the group has a critical opportunity to promote a stronger international monetary system.



THE G20 SHOULD:

1. Refocus its political agenda on financial and monetary stability measures and support reform of the international financial architecture beyond merely improving the IMF quotas;
2. Prioritize reforming the Fund's SDR Department as a central monetary system to exchange both traditional global currencies and also new emerging currencies, to serve as connection between regional and bilateral currency swap networks;
3. Establish guidance for the reform of the SDR Department at the IMF, including recognizing the role of emerging countries' currencies in the system and considering frequent new allocations or cancellations of SDRs, according to the global needs of liquidity;
4. Facilitate a "coalition of willing" among the largest emerging countries, concerned advanced economies and other developing countries, with the Bank for International Settlements (BIS) as manager, to replicate the institutional design of the Fund's SDR Department.

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EMERGING COUNTRIES' MONETARY POLICY: FRAGMENTATION AND DIVERSIFICATION OF THE INTERNATIONAL MONETARY SYSTEM

After the 2000s, many developing and emerging countries resorted to a model of unilateral monetary action, building up foreign exchange reserves. This policy was reinforced in the aftermath of the 2008 crisis. Even though the stockpiling of reserves implies a transfer of resources from developing countries towards developed economies (whose central banks issue the global currencies that are in demand, i.e. mainly the US dollar and to a lesser extent the Euro), its accumulation also gave political leverage to emerging countries once the 2008 crisis hit (Duran, 2015). They were free to choose their lender of last resort, and the biggest emerging countries in Latin America and Asia systematically avoided multilateral institutions, especially the IMF.

As a result, the fragmentation of the international monetary system has increased since the 2008 crisis. The accumulation of foreign exchange reserves allowed emerging countries to create or strengthen regional arrangements, pooling their resources in global currencies. In addition, some emerging countries – especially in Asia – started to promote the cross-border use of their national currencies, introducing possible alternatives to the US dollar as international money.

This diversification of the global monetary system has crucially relied on one under-studied phenomenon: currency swaps between central banks. The aftermath of the 2008 crisis witnessed the growing formalisation or reinforcement of swap networks and regional monetary arrangements based on the same legal structure as swaps. The expansion of swaps as a means of providing liquidity is a product of the growing political and economic power of central banks in the international arena (Duran, 2015).

Swaps have exploded in the post-2008 era: agreed to in growing numbers and vast sums, and concluded in an expanding number of currencies beyond US dollars. Regional networks based on US dollar swaps include Chiang Mai Initiative Multilateralization (CMIM) and the BRICS' Contingent Reserve Arrangement (CRA). At present, there is a US\$ 1 trillion network of swaps (excluding the *unlimited* size of the US Federal Reserve's swaps among six developed countries) and the 70 new arrangements concluded between 2010 and 2014 involving more than 50 countries (McDowell, 2015). By comparison, the IMF's financial capacity appears meagre. The Fund has only US\$ 362 billion in quotas. Its funding was boosted by the G20 meetings after the 2008 crisis, and it today amounts US\$ 885 billion, but only as temporary additional pledges and committed resources.¹

These alternative monetary arrangements are welcome additions to sustaining global liquidity. *But, in the event of crisis, how will these monetary networks respond?* The G20 is still not taking action on the connections between the three levels of international liquidity – multilateral, regional and bilateral. It must address the risks posed by future monetary challenges and work on the sustainability of international liquidity in a variety of currencies.

While swaps have vastly increased the amount of liquidity available, there are serious concerns about reliability and stability. Currency swaps, even if underpinning formalized regional agreements, are only *committed resources*, i.e. they are kept at national hands until their activation. There is no transfer of resources towards an international organisation. This institutional arrangement tends to contribute to uncertainty about the access to international money in times of crisis.

Furthermore, these networks are hierarchical, not horizontal. Central banks choose which counterparties to extend swaps to, and they choose mainly on the basis of economic development – that is especially the case for the US Federal Reserve swap network. The international hierarchy of money (Mehrling, 2012) is reproduced in these new monetary structures, with a seemingly less important role for international organizations at the multilateral level.

The last serious international effort to design institutions and effectively connect swap networks to the IMF appeared in 2010, when the IMF staff released the proposal of the Global Stabilization Mechanism (GSM) (IMF, 2010). Although it was endorsed at a conceptual level by the South Korean presidency of the G20, no progress was made.

Currently, the greatest challenge for the future of the international monetary system is to overcome this fragmentation and to design a predictable system for the exchange of currencies in times of crisis. Thankfully, however, this system already exists: the SDR Department at the IMF. Yet in order to function properly, the SDR Department is in need of substantial reform, which is highly subordinated to the swings of US domestic politics.

As a secondary option, the SDR Department can serve as an institutional model to recreate a multilateral framework to exchange global currencies. A G20-led "coalition of willing" can establish this mechanism to connect central banks from advanced, emerging and developing countries. The Bank for International Settlements (BIS) – where G20 central bankers are currently working to reform the global financial system through the Basel Committee – could manage this counterpart monetary system. Since the BIS historically sustained the Bretton Woods' *par value* system in the 1960s as a counterpart of currency swaps among advanced central banks, this proposition thus would revive the monetary role of the BIS.

1 "Fast facts on the IMF" available at the Fund's website: <http://www.imf.org/external/np/exr/facts/glance.htm>.

THE WAY FORWARD: A REVITALIZED SDR DEPARTMENT

To respond to the current fragmentation of the global monetary system, I propose, as first-option, to improve the SDR from what it is today: a managed and government-driven *monetary system* to ensure access to global currencies. The SDR is a reserve asset. It is not issued by the IMF, but merely allocated by it, thus the SDR does not represent a liability against the Fund, but is instead a *potential claim* on “freely usable currencies”. After 2009, discussions of the SDR have mainly focused on it as international money *per se* and not as a monetary system.

Reforming the SDR system would allow it to produce the same economic benefits as the existing networks of bilateral currency swaps, but a stronger SDR would have two key institutional advantages over the existing less formal networks. First, the IMF facilitates the conversion of currencies through voluntary trading, but could also activate the designation mechanism, i.e. in the event there are not enough voluntary buyers for the SDR, the Fund can designate members with strong position in their balance of payments to provide freely usable currencies.² This is a crucial legal mechanism in times of crisis, although it has never been used in the history of the IMF.

The second advantage is that the SDR, as an “intermediate” currency, facilitates the access to global money by deficit countries and could diminish the credit risk for surplus countries, distributing it across the system. A multiplier of the SDR net cumulative allocation determines the exposure of each country to this risk.³ The SDR as a collateral may favour the access to international money by smaller developing countries and can serve as a mechanism for crisis mitigation.

In order for the IMF’s SDR Department to play this role, however, five key reforms are needed:

- i. the **total SDR allocation must be expanded** to adequately meet the needs of the largest emerging countries;⁴
- i. **SDR allocation must be de-linked from the Fund’s quotas**

² See article XIX, Section 4 of the IMF’s Articles of Agreement.

³ See Section 4(a) of the Fund’s Article of Agreement: “(...) A participant’s obligation to provide currency shall not extend beyond the point at which its holdings of special drawing rights in excess of its net cumulative allocation are equal to twice its net cumulative allocation or such higher limit as may be agreed between a participant and the Fund.”

⁴ Brazil, South Korea and Mexico are examples of how low the current impact of the SDR is – for instance, all had bilateral swaps with the US Fed during the crisis that outstripped their SDR allocations. By contrast, since the last SDR allocation in 2009 Ecuador has been making use of its SDR allocation. The total value of Ecuador’s SDR holdings coincides with its borrowing arrangements at the Latin American Reserve Fund (FLAR) to deal with the 2008 crisis (Duran, 2015). The suppression of reconstitution requirement made the SDR a quasi permanent transfer to countries like Ecuador.

to increase its relevance for emerging and developing countries (and further enlarge its demand);

- i. **The IMF needs flexibility to allocate and cancel SDRs** according to the needs for international liquidity, removing the high institutional constraint currently in place (85% voting power);
- i. The requirement of at least a partial **reconstitution of allocations**⁵ must be reinstated, i.e. countries that had used their SDR should restore partially their holdings upon an agreed time. The reconstitution could be linked to indicators that reveal the deficit countries’ capacity to repay;
- i. The **SDR basket of currencies must be expanded** to include some emerging currencies, to reinforce the perception of system legitimacy and assure access to other sources of international money. The IMF can use the currency weight in the SDR value and interest rate to manage financial stability with the aim of avoiding too large swings in the basket. The representativeness of the currency basket could be broadened without affecting overall SDR stability if the total number of currencies in the basket remains relatively small.

THE NEED FOR POLITICAL LEADERSHIP FROM THE G20

Reforming the SDR along such lines is more feasible than the internationalization of the SDR as money *per se*, but it is still politically difficult. Important measures require major changes to the Fund’s Articles of Agreement and therefore the United States’ explicit acceptance (requiring approval of both executive and legislative branches in the US). That is why greater engagement from other G20 countries is needed, and the only way to do this is by narrowing the G20 agenda to focus more squarely on monetary stability reforms. This will prompt more political pressure to compel the US to agree to reforms.

The G20 is an important forum for discussions on currency swaps, because its member countries are the issuers of existing and new international monies. Furthermore, it is in the G20’s interest to restore the role of multilateral institutions for financial and monetary cooperation in an emerging multi-currency world. These proposed reforms thus demand G20 support and guidance.

Here the current and the next presidencies can play a central role: Turkey and China, as representatives of emerging countries’ interests, should focus on the political debate of monetary and financial regulation (especially lender of last resort functions) and propose reforms to the Bretton Woods system. The Think20 (T20), a group of think tanks that supports the

⁵ Article XIX, Section 6, b, Fund’s Articles of Agreement.

G20 meetings, already brought the SDR reform to the attention of policy makers (CIGI, 2015). Certainly, the project of expanding the role of the IMF through the SDR Department, or the creation of an alternative monetary system at the BIS, is a long-term goal, but important measures could be reached already in the next year.

For instance, in the next SDR review, the IMF will decide if the Chinese currency, the Renminbi (RMB), is going to be part of the SDR basket (IMF, 2015). This decision could have major impacts on the future design of the global monetary system. It has the potential to increase demand for the RMB at the international level as a reserve asset, to reinforce China's policies towards the internationalisation of its currency, but most important to change the actual concept of international currency, possibly de-linking it from the idea of full capital account convertibility (Lubin, 2015).

The IMF will also consider whether a "freely usable currency" requires full convertibility or not. It is, above all, a political judgement. If the IMF de-links these concepts and incorporates the notion of "managed convertibility" proposed by China, it would reinforce the emergence of a multipolar system in which different international monies could be in real competition with the US dollar. This movement could favour more cross-border use not only for the RMB, but also other emerging currencies, including the Korean won.

Despite the recent depreciation of the emerging countries' currencies, the internationalization process will certainly continue because there are government-driven mechanisms sustaining the use of these currencies as monetary and investment vehicles at the global level, such as the bilateral swaps between central banks as well as cross-border payments infrastructure. In fact, the recent monetary turbulence in emerging markets only confirms the urgency of the reforms proposed here. An improved Fund's SDR Department, or an alternative monetary system at the BIS, could contribute to assure official mechanisms to access other currencies besides the US dollars.

CONCLUSION

The best candidate for a multilateral forum in a fragmented and diversified liquidity environment is the IMF's SDR Department. In order for it to play this role, however, it needs more flexibility and new allocations, all of which require the full engagement of the US. A second-best option is a G20-led "coalition of willing" that duplicates an improved SDR Department in another institution. The BIS is a good candidate to manage this "new" system.

The G20 Turkish and Chinese presidencies have a huge opportunity: putting emerging countries' concerns on the agenda and reviving the debate on international monetary and financial reform that has been systematically neglected by the G20 in recent years. Access to global currencies is a critical and pressing issue, especially for emerging countries. The G20 should work towards this aim and effectively prepare a robust infrastructure for liquidity for the next global crisis, before it is too late.

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