G20 Think Tank 20 conference: The G20 and global governance
14-15 December 2015, Beijing, China

# The G20 is not ready for the next crisis

Measuring the inadequacy of the global financial safety net

**Adam Triggs**

Researcher, Crawford School of Public Policy
Australian National University

## Abstract

One-third of the IMF's funding will evaporate over the next two years as bilateral loans negotiated in 2012 start to expire. This is a major problem. In a global economy fraught within downside risks, the global financial safety net — essentially the resources provided by the IMF and other institutions reserved for fighting crises and preventing contagion — is too small, too unresponsive and too fragmented. This paper maps the evolution of the global financial safety net over time; quantifies its size by adding together its multilateral, regional and bilateral components; assesses its adequacy against potential global economic shocks and makes practical recommendations on how the Chinese G20 presidency can address these challenges.

# The G20 is not ready for the next crisis

Adam Triggs

## 1. Introduction

Over the past 20 years, the global financial safety net has dramatically increased in size and changed in composition. In 2003, the safety net consisted solely of the IMF and the US$365 billion it held to fight crises. Today, it is about seven times larger, at around US$2.75 trillion. However this increased size has come at the cost of increased fragmentation. The safety net consists of a multilateral component (the IMF, which now represents just 50 per cent of the safety net), a regional component through the European Stability Mechanism, the Chiang Mai initiative and the BRICS Bank and a bilateral component through currency swap lines.

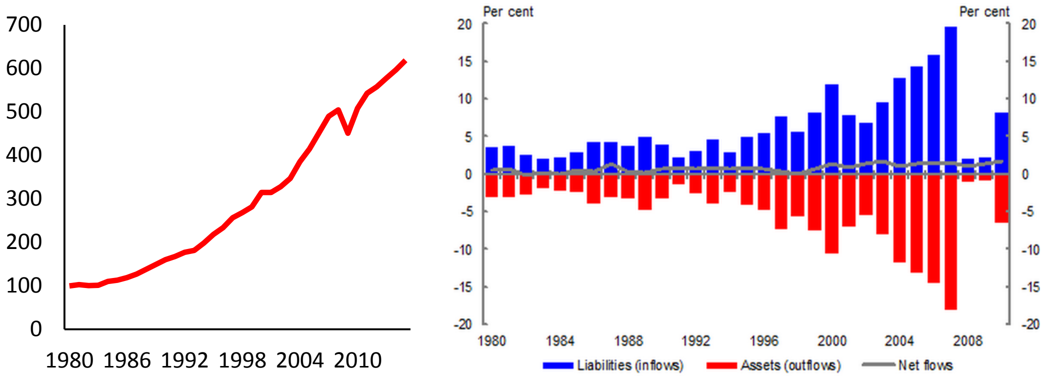
Although this safety net seems large, this paper shows it is inadequate for several reasons. First, only US$1.08 trillion of this US$2.75 trillion is currently available. This is too small to deal with a major crisis. Greece represents just 0.25 per cent of global GDP, but if the IMF was to shoulder the Greek bailout on its own almost 70 per cent of its capacity would be exhausted. The fragmentation of the safety net also conceals its true size. For most countries the safety net consists entirely of the IMF since they do not participate in any regional initiatives or bilateral swaps. Fragmentation has also reduced the speed at which these mechanisms can respond to a crisis. And finally, these regional initiatives are weak substitutes for the IMF.

The Chinese G20 presidency needs to fix this problem. In September 2015, G20 finance ministers commissioned the IMF to provide an assessment of the safety net in early 2016. This should form the basis of a renewed push from the G20 to strengthen the safety net. This paper outlines a number of practical things the G20 can do, including furthering IMF reform, improving institutional cooperation between the IMF and regional financing arrangements and renegotiating the $369 billion of bilateral IMF loans that are about to expire.

## 2. The evolution of the safety net

The safety net supports stability by acting as a financial backstop, providing emergency financing where a country is unable to meet external payments and cannot access markets (Sterland, 2013). The safety net also acts as a form of insurance (Shafik, 2015). Countries contribute resources to the safety net and, knowing they will receive assistance if they experience problems with their external payments, are more willing to open their economies. Most importantly, the safety net reduces systemic risk by preventing economic contagion from one country to another. In an increasingly interconnected world (Figure 1), this is fundamental.

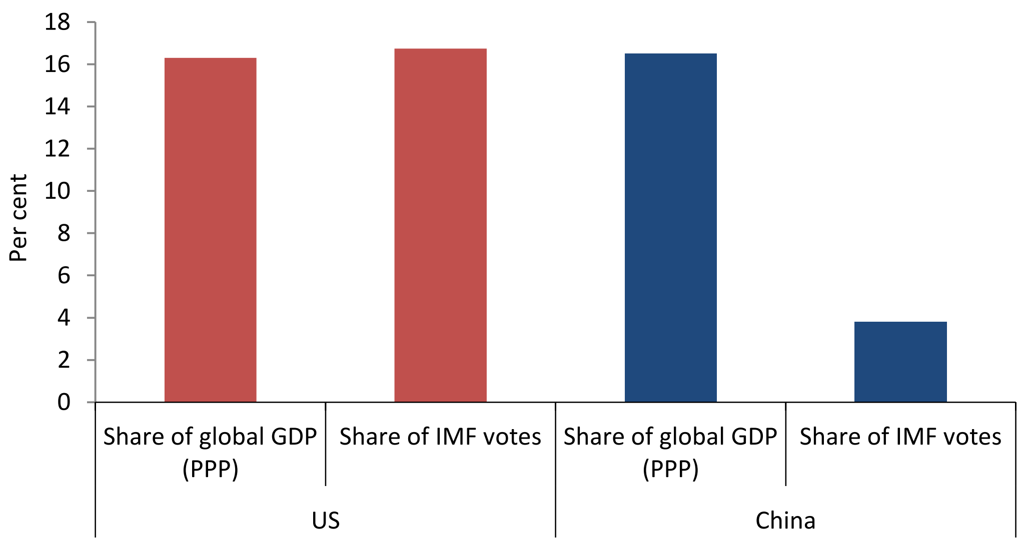
**Figure 1: Global trade and capital flows have increased more than 5-fold since 1980**




Source: IMF, October 2015; and Australian Treasury, 2014

Before the crisis, the safety net consisted entirely of the IMF and the $365 billion it held to fight crises (Treasury, 2014). Since then, the safety net has changed in two ways: it has significantly increased in size but has also fragmented in composition. There are several reasons for this fragmentation. The most significant is the G20's inability to reform the IMF so as to boost its funding and make its governance structure more representative of the global economy in the 21st Century. For example, in 2015 China accounts for about 16 per cent of global GDP (PPP) but only 4 per cent of IMF votes (Figure 2). In 2010, the G20 agreed to partially remedy this by transferring 6 per cent of the overall quota share from advanced economies to emerging market and developing economies. Although this was endorsed by all G20 countries, including the US Administration, the US Congress has repeatedly refused to pass these reforms.

**Figure 2: US and China's shares of global GDP and IMF voting power**



The inability to reform the IMF has made it more reliant on secondary sources of funding, such as bilateral loan commitments, and has made the global economy more reliant on regional financing arrangements outside of the IMF. In 2010, the euro area created the European Financial and Stability Fund, which later became the European Stability Mechanism, to respond to the European debt crisis. Similarly in 2010, BRICS countries created the $100 billion BRICS Bank and the 10 members of ASEAN plus China, Japan and South Korea created the Chiang Mai initiative – a $240 billion pool of foreign exchange reserves to help manage regional liquidity problems.

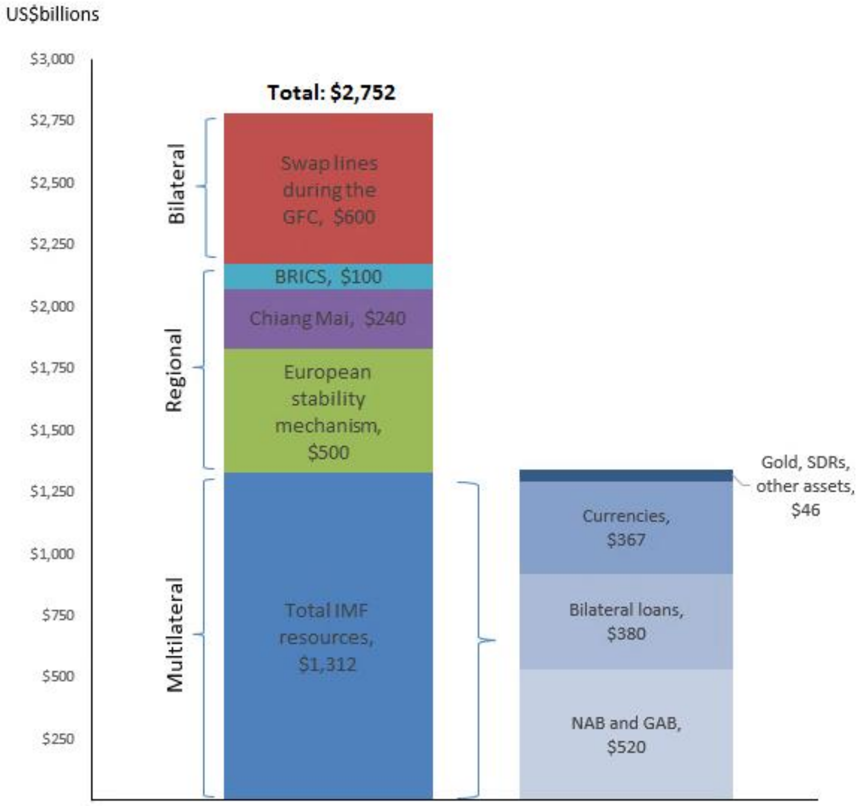
For the emerging market economies, these initiatives were partly because of insufficient IMF resources but were also because of dissatisfaction with the IMF's response to the Asian Financial Crisis and the inability to reform the institution. This has also seen countries increase domestic and bilateral buffers through foreign exchange reserves and bilateral swap lines, respectively. Foreign exchange reserves have increased from less than $2 trillion in 1990 to over $11 trillion in 2015 while the value of currency swaps during the global financial crisis totalled $600 billion.

## 3. Quantifying the size of the safety net

Quantifying the size of the safety net means adding together its multilateral, regional and bilateral components (Figure 3). The global component is the IMF. As of June 2015, the IMF has total resources of US$1.3 trillion. The regional component, which includes the European Stability Mechanism, the Chiang Mai initiative and the BRICS Bank, totals around $840 billion. Finally, while comprehensive information on swap lines is rarely made public, a good proxy for the size of these swaps during a time of crisis is to use the swap lines created by the US Federal Reserve with 13 other central banks during the global financial crisis. These swap lines totalled $600 billion.

Adding these components together, the overall safety net is around $2.7 trillion in size: about 50 per cent comes from the IMF, 20 per cent from swap lines, 20 per cent from the ESM and 10 per cent from BRICS and Chiang Mai. While domestic foreign exchange reserves could be added as a fourth component, these reserves are generally a country's first line of defence. As such, they are no more part of the global financial safety net than an economy's macroeconomic policy space more generally. Foreign exchange reserves are, however, an important consideration since these resources often directly or indirectly contribute to global and regional initiatives. China's foreign exchange reserves, for example, are systemically important to the Chiang Mai initiative, BRICS Bank and bilateral swap lines.

**Figure 3: The components of the global financial safety net**



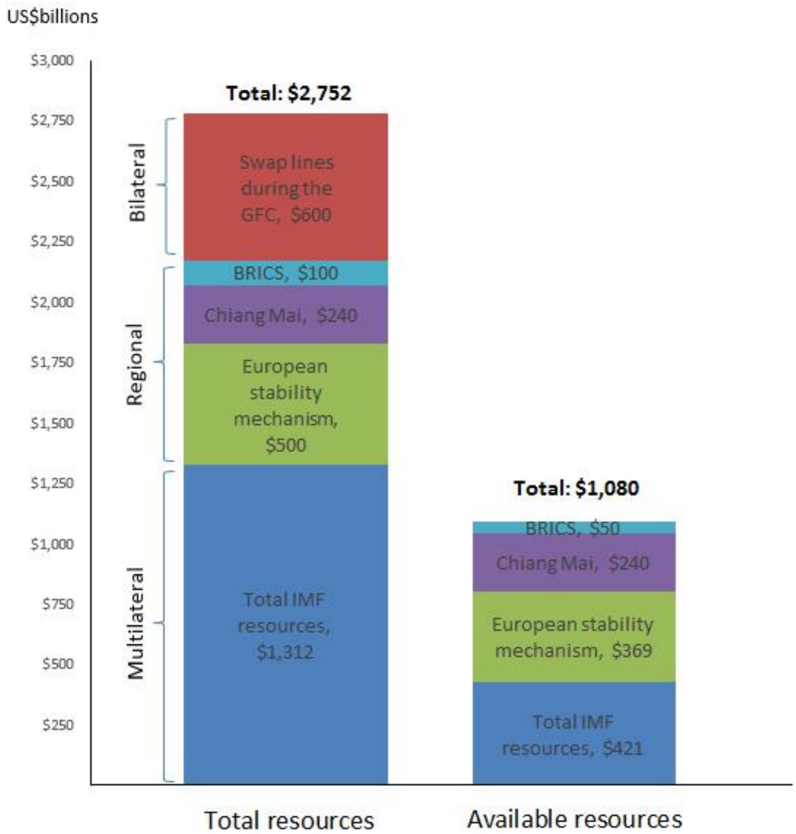

## 4. Assessing the adequacy of the safety net

The adequacy of the safety net relates to its size and composition. Countries are now more exposed to one another than ever before, so a larger safety net makes sense. But the $2.7 trillion figure represented above overstates the adequacy of the safety net for several reasons.

First, not all these resources are available immediately. Figure 4 shows that, if we exclude resources that are not immediately available, the size of the safety net more than halves to about $1.08 trillion. For the IMF, most of its resources are tied up in existing programs or come from borrowing commitments which have not been paid-in. As a result, its resources drop from $1.3 trillion to $421 billion. Similarly, the forward commitment capacity of the European Stability Mechanism drops from $500 billion to $369 billion and, for the BRICS Bank, from $100 billion to $50 billion. We can also exclude the currency swap lines from 2008 since these no longer exist, are not immediately available and would need to be reopened by the US Federal Reserve, something which is by no means guaranteed.

Second, whether $1.08 trillion is adequate or not depends on the size of the crisis that the safety net is responding to. Greece, for example, represents just 0.25 per cent of global GDP (PPP). But if the IMF was required to shoulder the burden of the Greek bailout on its own (which has been around $279 billion since 2010), this would occupy almost 70 per cent of the IMF's capacity. A worse scenario is for a larger economy, such as Spain. Spain represents 1.5 per cent of global GDP and has $669.5 billion of debt to refinance in the 5 years from 2015 to 2020 (Bloomberg, 2014). This would exhaust the IMF's entire capacity and most of the ESM.

**Figure 4: Total resources compared to available resources**




Third, the adequacy of the safety net depends on what is meant by the term 'global'. The actual size of the safety net depends on the country in question. For many countries, like Australia, the safety net consists entirely of the IMF since it does not participate in any regional initiatives. Similarly, swap lines are only available to those who can negotiate them, and it is worth noting that emerging market and developing economies were excluded from the Federal Reserve swap lines in 2008.

Fourth, market confidence is reduced when investors are unable to see a designated war chest and necessary institutional arrangements to respond to a crisis. Assuming ad hoc international cooperation will be forthcoming during a time of crisis is not conducive to market confidence. It also erodes the implicit insurance policy which encourages countries to open their economies in the first place (See Shafik, 2015).

Finally, these regional financing arrangements are weak substitutes for the IMF. As outlined by Sterland (2013), the closeness of countries that participate in regional arrangements means that imposing potentially painful but necessary conditionality can be difficult and uncomfortable. The narrower base of resources means they are less reliable, less diversified and more risky for contributing countries. Surveillance activities also tend to be partial as the global picture is not as obvious.

For these reasons, the IMF must remain at the centre of the global financial safety net. Its diverse membership and long history provides the IMF with several unique features that are irreplaceable at a regional or bilateral level. The IMF has the greatest capacity to raise resources in times of need and to ensure that credit risk is diversified globally to the greatest extent possible. As such, it provides the most effective and low cost insurance against crises (Sterland, 2013).

## 5. What should the G20 do?

China's G20 presidency presents an opportune time to focus on the global financial safety net. In 2016 and 2017, around $369 billion of the IMF's funding will expire. China should use its presidency to focus the G20 on the global financial safety net from three perspectives: IMF reform and expansion of the SDR basket, implementing arrangements to make the IMF and RFAs more cohesive and renegotiating bilateral loans.

IMF reform is the linchpin for addressing the challenges facing the global financial safety net. China's G20 presidency will present an awkward contradiction where the country chairing the world's steering committee, the G20, remains grossly underrepresented in the IMF. This contradiction should be exploited during China's G20 presidency. In September 2015, G20 finance ministers and central bank governors commissioned the IMF to undertake an assessment in early 2016 of the global financial safety net. This should form the basis for a renewed push for IMF reform and ratification of the 2010 reforms by US Congress.

On 13 November 2015, IMF staff recommended the Yuan be included in the SDR basket (IMF, 2015). China, of course, continues to have a key role to play. Liberalisation of China's capital account is pivotal not only to the Yuan's inclusion in the SDR, but also for China to play an increasing role in the global economy more generally. Capital account liberalisation is also key to the internal rebalancing of the Chinese economy, external rebalancing of the global economy and facilitating further integration and stability in the region.

While reforming the IMF is the best way to address the challenges facing the safety net, there are other steps that can be taken to make the patchwork of global and regional initiatives more cohesive. Regional and bilateral initiatives can have an important role within the safety net, but they must be rigorous and structured so as to complement the IMF. At the Cannes Summit in 2011, leaders endorsed 'G20 Principles for Cooperation between the IMF and Regional Financing Arrangements' (G20, 2011). This should be used to develop an overarching framework for better cooperation between the IMF and RFAs.

Such a framework could be gradually developed and strengthened through informal and formal methods. Informally, regular dialogues could be held between the IMF and RFAs to reach a better understanding on how to coordinate with each other, such as establishing procedures for information sharing and jointly conducting crisis scenario exercises. This suggestion was put forward by Korea in 2012 and received broad support (G20 India Secretariat, 2014). It has also been canvassed by the IMF (2013) as a practical step to fine-tune the current flexible approach to IMF-RFA cooperation.

More formally, the G20 could task a working group to develop detailed guidelines on IMF-RFA cooperation. Such an agreement could formalise the expectation that co-financing operations would be subject to certain principles and safeguards, similar to those stipulated under the Fund's lending framework. The detailed guidelines could provide concrete guidance on how these principles could be achieved. This proposal has also been canvassed by the IMF (2013) and should be considered in detail by the G20.

Finally, the expiration of $369 billion of IMF bilateral loan funding over 2016 and 2017 requires an urgent response from the G20. This funding represents a third of the IMF's funding and introduces an unacceptable amount of systemic risk into the global economy at a time when many economies are going through difficult transitions. These loans must be renewed. To ensure this is not be treated as acquiescence of the current ad hoc situation, the renewal of these loans should be accompanied by greater lobbying efforts by the G20 to Congress, potentially in the form of a joint letter co-signed by all G20 leaders, as well as through the above practical steps to improve IMF-RFA cooperation.

## 6. Conclusion

The key message from this paper is that, in a global economy fraught within downside risks, the global financial safety net is too small, too unresponsive and too fragmented. Of course, safety nets are not a panacea for all ills. They are, and should remain, a last resort. The first line of defence for any country is to ensure sound macroeconomic frameworks to cushion against economic shocks and ensure flexible responses (Sterland, 2013). But there are nevertheless practical things the G20 can do to strengthen the safety net.

Reforming the IMF is the linchpin for addressing the challenges facing the global financial safety net. The report from the IMF on the adequacy of the safety net in early 2016 should form the basis of a renewed push from China to strengthen the global financial safety net, both through IMF reform, better cooperation between the IMF and RFAs and through a renewal of bilateral loan commitments. Importantly, by packaging these initiatives together, renewing these bilateral loans will be more palatable to the emerging market economies who, in return for their funding commitments, do not receive any additional voting power.

## 7. References

**Australian Treasury, 2014**. Is the global financial safety net at a tipping point to fragmentation? Adam Hawkins, Jyoti Rahman and Thomas Williamson. Economic Roundup Issue 1, 2014. Available at: http://www.treasury.gov.au/PublicationsAndMedia/Publications/2014/Economic-Roundup-Issue-1/Economic-Roundup-Issue-1/Global-financial-safety-net#P8_195.

**Bloomberg, 2014**. Europe's Debt Time Bomb. Mark Gilbert, 20 May 2014. Available at: http://www.bloombergview.com/articles/2014-05-20/europe-s-debt-time-bomb.

**G20, 2011**. G20 Principles for Cooperation between the IMF and Regional Financing Arrangements. 15 October 2011. Available at: http://www.g20.utoronto.ca/2011/2011-finance-principles-111015-en.pdf.

G20 India Secretariat, 2014. Regional Financial Arrangements (RFA) and Cooperation with the IMF. G20 India Secretariat, Government of India, ministry of Finance, Department of Economic Affairs, 30 December 2014. Available at: http://www.g20india.gov.in/finance-ifar-rfa.asp?lk=finance5.

**IMF, 2013**. IMF Explores Ways to Enhance Cooperation with Regional Groups. IMF Survey Magazine: Policy, 2 July 2013. Available at: http://www.imf.org/external/pubs/ft/survey/so/2013/POL070213A.htm.

**IMF, 2015**. Statement by Ms. Christine Lagarde on IMF Review of SDR Basket of Currencies. Press Release No. 15/513, November 13, 2015. Available at: https://www.imf.org/external/np/sec/pr/2015/pr15513.htm.

**Shafik, 2015**. Fixing the global financial safety net: lessons from central banking. David Hume Institute, Edinburgh, Scotland, 22 September 2015. Available at: http://www.bankofengland.co.uk/publications/Pages/speeches/2015/841.aspx.

**Sterland, 2013**. Priorities for Australia's presidency of the G20 in 2014 and the role of the global financial safety net. The Shilla Seoul, Korea, 19 December 2013. Available at: http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2013/Priorities-for-Australias-Presidency-of-the-G20.