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IMPLEMENTING GLOBAL FINANCIAL SAFETY NETS

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KEY POINTS

- Extension of deposit guarantees by governments and expansion of assets against which central banks have lent was necessary to manage the global financial crisis. Retreat to more normal conditions must be accomplished without shaking market confidence.
- Expansion of the system of financial safety nets may be necessary to prevent future crises; this must be done in a way keeping in mind that additional moral hazard is not created.
- The G20 should study expanding the policy toolkit to prevent excessive lending to particular sectors.

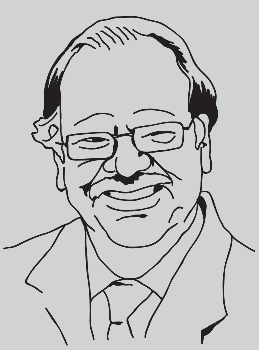
The G20 has sought to reduce systemic financial risk by improving the resilience of financial institutions, making financial markets more robust, and reducing interconnectedness among financial institutions and between institutions and markets. To bolster the global financial system, the G20 leaders in Toronto in June called for strengthening global financial safety nets to address capital flow volatility, financial fragility and crisis contagion.

Financial safety nets enable countries with good polices to insure against bad outcomes, especially when caught as innocent bystanders in financial turmoil. In response to the recent crisis, the International Monetary Fund (IMF) introduced a new Precautionary Credit Line (PCL) and made improvements to its existing Flexible Credit Line (FCL) for countries that meet rigorous pre-set qualification criteria. The improved FCL eliminates caps on access to IMF resources for short-term liquidity and lengthens the required repayment period. The PCL is for those countries that do not meet the high FCL standards, but are able to meet a weaker set of qualifying conditions.

Since the Asian financial crisis of 1997–1999, some countries have sought to self-insure themselves against balance of payments crises by accumulating large foreign exchange reserves. The case for such pre-emptive reserve accumulation may have lessened recently, given the greater availability of IMF resources and the Fund's new credit lines. Even more liberal access to Fund resources may be sought at Seoul, and such actions can only contribute to resolving the problem of current imbalances

MORAL HAZARD PROBLEMS

The key design element for financial safety nets (FSNs) is that agents remain responsible for their own decisions. Overly liberal access to an FSN can create moral hazard, which is why, traditionally, domestic safety nets dealing with banks have limited relief under the three pillars of deposit insurance, lender of last resort (LLR) and wind-up or resolution rules. For example, governments insure deposits



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only under a certain amount; large depositors are assumed to have the capacity to monitor banks' performance. Access to LLR facilities should, by the canons of central banking, be at a penal rate, and central banks should lend only against "good" collateral. Shareholders and, to a lesser extent, bondholders may suffer large losses in restructurings under resolution procedures. In addition, authorities attempt to limit the risk of moral hazard through regulation and supervision.

At the international level, the moral hazard concern arising from uncapped access to the IMF's FCL and the lengthened repayment period are mitigated by the fact that borrowing countries must meet the pre-qualification standards and the IMF executive board must approve the application. Access to the facility is not automatic. The possibility of moral hazard arising from the lower standards set for the PCL is limited by the lesser amounts available under the PCL and, perhaps, the desire of countries to graduate to the FCL.

Moral hazard has been a central concern during the global financial crisis. At the national level, for example, governments have extended deposit insurance and expanded the range of assets that central banks accept as collateral. Questions have followed regarding how governments will return to more normal deposit guarantees, and how central banks will remove the assets they acquired during the crisis from their balance sheets. This adjustment back to relatively normal conditions must be accomplished without shaking the confidence of markets.

Internationally, several funds have been set up at the regional level, in Europe and Asia, to assist countries facing capital outflows or countries in need that cannot access global financial markets. The rules governing the operation of these regional funds, and the relations between these funds and the IMF, should be clarified to reduce the possibility of moral hazard arising from access to different funds with differing requirements.

REMAINING ISSUES

As is well known, recent financial crises have ensued as a result of excess lending to particular economic sectors, usually housing. As G20 leaders review efforts undertaken so far to achieve global financial stability, it may be worthwhile examining how general macro policy instruments in the monetary or fiscal fields can be supplemented to control sector-specific lending exuberance without pushing the overall economy into a recession. The question to be studied is whether strengthened regulation and supervision, along with global financial safety nets, is sufficient for global financial stability, or whether additional policy instruments or special regulations are necessary to curb excessive lending within specific sectors of the economy. This should become part of the G20's considerations.

The extension of IMF resources and its credit lines strengthen the IMF's role as a lender of last resort. The G20 now has to deal with the third aspect of the global financial safety net, namely the wind-up of international private financial institutions — for example, the banks in Iceland — and the risks posed by systemically important financial institutions known as the "too-big-to-fail" problem.