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Cash or Credit?

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OVERVIEW

Bottom line: In the face of uncertain capital flows, an international network of swap lines would help to ensure adequate liquidity and act as a significant enhancement of the global financial safety net.

Should the International Monetary Fund (IMF) and major central banks provide credit lines to countries facing sharp outflows of capital? In 2007, 2010, and 2011, the Federal Reserve's dollar-swap lines with other central banks played a critical role in stabilizing markets and ensuring an adequate supply of dollar liquidity. Now, in the context of sudden reversals of capital flows ("sudden stops"), there are proposals for new swap or credit arrangements for emerging markets and for the periphery of Europe. These proposals have their virtues, though perhaps not the ones their proponents claim.

SWAP LINES, THE FED, AND THE IMF

The idea that the International Monetary Fund (IMF) should coordinate a global network of swap lines gained currency during the financial crisis, partly in response to complaints from countries excluded from the Fed's swap lines. The Fed's prudential concerns, along with a mandate to limit swaps to countries viewed as threatening global financial stability, highlighted gaps in the global safety net. In addition, the Fed's swap lines were temporary. The primary argument for a new arrangement rests on the observation that in today's financial markets—highly leveraged, complex, and interconnected—adequate liquidity is central to avoiding crisis. This suggests the need for something more comprehensive and permanent.

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This debate is not new. A group of Asian countries led by China launched a regional swap plan in 2010 (the Chiang Mai Initiative), and, in the run-up to the Seoul G20 Summit, the Koreans floated a proposal for a global network of swaps modeled on Chiang Mai. Around the same time, motivated in part by concern that the Asian arrangements would compete with it as a global financial authority, the IMF floated a proposal for an IMF-backed network of swaps. These proposals never gained broad support, and with the easing of the crisis the pressure for reform went away.

The catalyst for renewed debate was the reversal of capital flows from emerging markets, beginning in June, based on expectations that the Fed would begin to exit from quantitative easing. The most developed proposal comes from Ted Truman, who in a recent piece calls for a global network of central bank swap lines coordinated by the IMF. Central banks would retain control over the lines, though the IMF would identify the need and decide when systemic risks warrant activation of the lines. The plan would be a significant enhancement of the global financial safety net, though the complexity of the proposal, the magnitude of the liquidity commitments it requires from central banks, and the central role it gives to the IMF are sure to raise opposition in major capitals.

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EMERGING MARKETS: THE NEXT BIG CRISIS?

A number of emerging markets have seen a large capital outflow, precipitating sharp financial market moves and forcing a tightening of policies. Attention has focused in particular on the "fragile five"—Brazil, India, Indonesia, South Africa, and Turkey—countries with substantial financial markets, large current account deficits, and financial imbalances. But in other respects, it is hard to see these problems as the start of a systemic economic crisis. For example, in contrast to conditions at the time of the 1997 Asian financial crisis, most of these countries have substantially higher international reserves to act as a buffer against capital flow reversals. External imbalances are manageable and more of the debt is of longer maturity. Consequently, the risk of a sharp run on banks, which happened in Korea in late 1997, seems less likely. Markets have stabilized recently. Nonetheless, corporate and financial sector leverage remains high in many countries, posing an uncertain but continuing risk of runs.

PRECAUTIONARY AND CONTINGENT CREDIT LINES

Still, it is hard to argue against the notion that countries should do more to get ahead of a possible crisis and prepare for contingencies. The IMF offers credit lines to countries vulnerable to global shocks but with otherwise strong policies.[1] However, the stigma associated with turning to the IMF has limited the use of those programs. In 2011, the IMF discussed the possibility of simultaneously offering credit lines to a group of countries as a way of overcoming resistance to these programs. The idea was that prequalifying countries would lessen the pain associated with having to approach the IMF for support. The problem with this idea is what to do when a country's policies worsen, or are subsequently seen as inadequate. Drawing on a credit line cannot be a substitute for necessary policy reform.

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Even so, I see a case for an expanded use of precautionary lines as a signal to markets and to strengthen a country's defenses against market turmoil. Progress is possible in the current discussion of how to support countries in the European periphery. Ireland and Portugal may request contingent credit lines from Europe's Economic Stabilization Mechanism (ESM) to help them exit their IMF-supported adjustment programs. In Ireland's case, a contingent line would be a transitional arrangement to signal to markets that the country continues to have European

[1] The two main programs are a flexible credit line (FCL) for countries whose policies would be adequate absent global financial market volatility, and a precautionary credit line (PCL) for those countries where some policy changes would be needed.

support. In Portugal's case, a new bailout is likely, though both the government and its European creditors are loath to admit it. As a consequence, European leaders appear resistant to provide a credit line to Portugal; that is a pity. Moreover, other countries in the periphery could benefit from contingent lines from the IMF.

So what purpose do these credit lines serve? In practical terms the lines are the framework for the needed expansion of the safety net and for "more Europe." If this approach helps to achieve improved governance in Europe, then that would be a major step forward. More generally, a network of IMF-supported swap lines would strengthen the global safety net and provide an important buffer against future sudden stops in capital flows.

Looking Ahead: Kahn's take on the news on the horizon

The Cliff Is Dead, Long Live the Cliff
A U.S. government shutdown is in effect with no clear exit strategy. A far more material and potentially damaging standoff on the debt limit looms.

The World Bank and IMF Meet
Meetings later this week between the world's two major financial institutions will reveal anxiety about growth and capital flows, but offer little agreement on what to do about it.

Abenomics' Second Arrow
The issue is fiscal sustainability over the medium term, without killing growth. The decision to go ahead with the consumption tax is good on structural grounds but has renewed growth fears.