GENEVA REPORTS ON THE WORLD ECONOMY

Chapter 4: The Future of the International Financial Architecture in a Geopolitically Fragmented World

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The international financial architecture

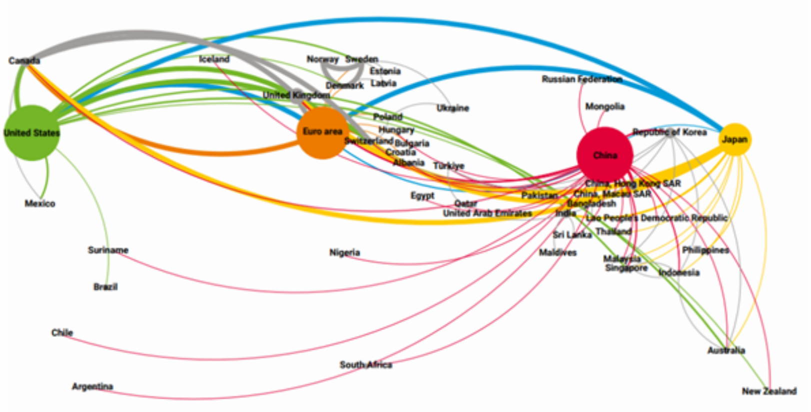
The Global Financial Safety Net

The Global Financial Safety Net

- **What is the GFSN?**
  - A collective set of mechanisms aimed at mitigating financial instability risks in an interconnected global financial system.
  - A multi-layered system designed to prevent and respond to financial crises (Aiyer & Ilyina, 2022).
  - Emergency liquidity provision during balance of payments issues, currency crises, or systemic shocks.
- **Components of the GFSN:**
  - Foreign Exchange Reserves
  - Bilateral Central Bank Swap Lines
  - Regional Financing Arrangements (RFAs).
  - International Monetary Fund (IMF). Provides financial assistance on a global scale.

The Global Financial Safety Net

Figure 1: Bilateral swap line networks, 2022



Sources: Global Financial Safety Net Tracker.

Central Bank Swap Lines/Repo Facilities

- **Benefits: Swap lines & Repo facilities offer emergency liquidity support during periods of market stress.**
  - Fed Swap lines (standing & temporary)
  - FIMA Repo facility
  - EUREP facility

- **Limitations: Uneven access to liquidity support:**
  - Major developed economies.
  - Excludes most EMDE access to dollar/euro liquidity.
  - Governed by closeness of economic/financial ties.

- **FIMA Repo:** emergency dollar liquidity access, broader set of countries during crises. Liquefy UST holdings.

The IMF, Reserves and Regional Financing Arrangements

- **The IMF is an indispensible component of the GFSN:**
  - Emergency financial assistance through various instruments during crises.
  - Challenges: Stigma, policy conditionality, governance & representational issues.
- **Reserves: Reserves offer immediate, self-insured support.**
  - primary domestic defense against liquidity shortages and speculative attacks.
  - Costs: low-yield assets, sterilization costs & inflationary pressures if inadequately sterilized.
- **Could RFAs gain traction?** In nascent stages, uncharted waters.
  - Several arrangements currently use USD as currency of choice.

The way forward in a geopolitically fragmented world

- The key mechanisms (Swap lines/IMF lending) of the GFSN require international cooperation $\rightarrow$ mitigate future financial shocks & ensure a more resilient global economy.
  - Financial statecraft: Tools for global financial stability. Also instruments of geopolitical strategy?
  - Chinese swap lines: foster economic ties & enhance geopolitical leverage.

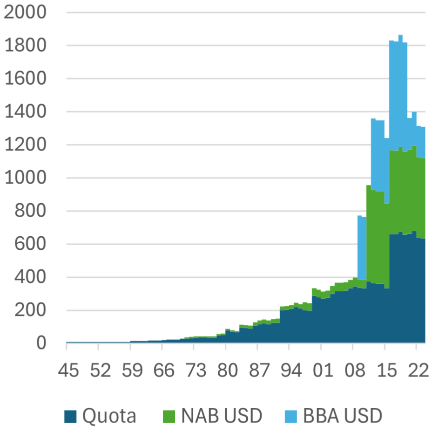
- Further fragmentation: will countries rely more on self-insurance? Unlikely to be optimal globally as does not comprise cooperation/risk-sharing at supranational level.
- Will other players (China) step in to fill the void if the United States no longer epicenter of the IMS?
- Would continued policy uncertainty in the U.S. create space for the Euro, Swiss Franc, etc. to increase market share for reserve assets?

The Multilateral Financial Institutions and International Forums

Geo-economic tensions come at a time when IMF lending capacity is under strain...and at a key moment for the IMF.

- IMF resources stand at 0.61% of world GDP.
- 16th quota reform expected to increase quotas by 50%. Agreed upon but not yet implemented.
- New Arrangements to Borrow (NAB) and Bilateral Borrowing Arrangements (BBA) are set to expire.

Figure 2: IMF resources



MFIs have adapted to changing global economic realities.....GEF will likely further complicate the governance landscape.

Figure 3: Deviation in pp in actual IMF quotas from IMF quota formula

Source: IMF finance department and authors calculations.

Sovereign debt restructuring

Sovereign debt restructurings and geoeconomic fragmentation

- **Sovereign debt restructurings are notoriously complex.**
  - Challenge: Absence of an international bankruptcy framework
  - Since the 1990s, a blueprint worked well for many years

  Main reason: Paris Club

- **The system was also able to adapt to remain fit-for-purpose.**

- Geopolitical fragmentation makes **coordination among creditor nations more challenging.**

- This could...
  - Delay restructuring
  - Constrain lending capacity
  - **Increase the pressure for multilateral institutions to participate in debt restructurings**

Heightened Pressure in a Fragmented World

IFA was already facing **growing challenges**

- Systemic shocks like COVID-19 exposed the need for cross-border coordination and bigger lending capacity.
- Traditional multilateral bodies under strain. Traditional approach to debt restructuring inadequate.

Fragmentation puts **heightened pressure on IFA**

- Harder to achieve global agreements. **Erosion of IFIs and forums for economic decision-making.**
- ... could lead to a roll back of surveillance and coordinated financial sector policies.
- ... could weaken GFSN's credibility.
- ... and may lead to the GFSN being inadequately resourced or too slow to deploy.

→ A fragmented order **threatens the GFSN's ability to act as a global crisis backstop**.

Thank you!