BANK OF ENGLAND

# News release

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## Fixing the global financial safety net: lessons from central banking – speech by Minouche Shafik

In a speech to the David Hume Institute in Edinburgh, Minouche Shafik, Deputy Governor for Markets and Banking, describes the global safety net for dealing with sovereign debt crises as "more of a patchwork than a safety net." The need to fix the safety net has been brought into sharper focus by the challenges facing emerging markets: lower growth, falling commodity prices and potential spillovers from the possible exit of exceptional monetary policy in advanced economies. Drawing on lessons from central banks' response to banks' liquidity needs during the financial crisis, she identifies policy reforms that could reduce the systemic implications of sovereign debt crises and allow nations to cope with shocks.

“The benefits of free trade are now well established. Similarly, economic theory provides compelling arguments for the potential advantages of integrated global capital markets based on the efficient allocation of resources. But, in practice, cross-border capital flows can be fickle and flighty, with destructive effects on the real economy.” They leave nations exposed to a ‘capital stop’, in much the same way that banks can experience a run on their deposits.

Minouche concludes that the current safety net – a mix of national foreign exchange reserves, regional financing arrangements, central bank swap lines and the International Monetary Fund (IMF) – is suboptimal: fragile, fragmented, and inefficient. If we are to continue to benefit from global financial integration then we need a system that can effectively and efficiently provide liquidity insurance to fundamentally sound sovereigns in order to contain spillovers to other parts of the globe.

Drawing on the experience of central banks, she notes that more reliable provision of liquidity support has been made possible by the fact that supervision is tougher on capital and liquidity

requirements, banks undergo regular stress testing, and credible resolution tools are being put in place. What would the equivalent enablers be for sovereigns? Minouche suggests:

- Better surveillance, and particularly of the vulnerabilities to sudden stops;
- Stress testing countries' balance sheets through better debt sustainability assessments; and
- Better mechanisms for dealing with debt restructuring and reducing the risk of disorderly spillovers.

Given the "complex and messy process whereby markets and the official sector deal with sovereign debt restructurings", how might the risk of disorderly spillovers be reduced? Three preliminary ideas are suggested:

- Using state-contingent bonds to increase risk-sharing with private sector creditors, for example GDP-linked bonds.
- Facilitating agreements on a debt restructuring in bond contracts by expanding the use of new style collective action clauses so that decisions can be taken by a majority of creditors across all bond issuances, without the need for an issuance-by-issuance vote.
- Reducing international spillovers by reviewing the preferential treatment that cross-border sovereign exposures receive in prudential regulation.

At the heart of the global safety net, Minouche suggests, needs to be a more reliably resourced IMF that has well defined arrangements for collaborating with regional financing arrangements. Unless improvements are made, it will be difficult to achieve and sustain the benefits of integrated global capital markets.

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