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Policy brief

INTERNATIONAL STANDARDS AND THE ROLE OF CENTRAL BANKS IN GLOBAL FINANCIAL GOVERNANCE

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ABSTRACT

The formal arrangements for the governance of international monetary and financial crises have remained reasonably stable over the past 40 years, but the identity of the leading actors, has changed. Over this period, the role of the largest central banks – first and foremost, the US Federal Reserve (Fed), currently the most important central bank due to the international role of the US dollar, the European Central Bank (ECB), the Bank of England (BoE), the People's Bank of China, and the Bank of Japan – has increased substantially. Unlike the situation with other global governance actors, there are no obviously applicable international standards to guide central bank conduct.

This policy brief discusses the implications of this development and recommends standards that should be used to guide central banks in their global governance activities.

CHALLENGE

The significance of the change in the identity of the institutions that, *de facto*, play the leading roles as global financial and monetary crises managers can be seen from a comparison of the international community's management of the sovereign debt crises in Latin America in the 1980s with its management of the monetary and financial consequences of the most recent global crisis, the current COVID-19 pandemic.[1] While there are many obvious and important differences between these two events, both posed systemic challenges requiring strong response from the key actors in global financial governance.

1980S SOVEREIGN DEBT CRISIS

By 1982, Latin American sovereign borrowers had incurred approximately US$327 billion in debts. This was equal to about 176% of the total capital and reserves of the systemically most significant US banks, their largest group of creditor banks (Sims and Romero 2013). By the end of that year, many of these countries had fallen into arrears on their interest payments and were in danger of defaulting on their debts. This had serious implications for the stability of their creditors. Given the global importance of these banks, their sovereign borrowers' problems also threatened the stability of the international financial system and the global economy. Both debtors and creditors turned to the International Monetary Fund (IMF) for help. It responded by providing financing to the debtor states on condition that they adopt certain policy reforms, that their creditor banks provide new financing and that they renegotiate their debts. The IMF's financing gave it sufficient bargaining power to force each debtor state and its creditors to accept this arrangement. International organisations like the World Bank and the Bank for International Settlements (BIS) and the banks' home states provided additional financial support.

For example, Mexico's total debt in 1982 was about US$80 billion. Mexico's interest payments that year were equal to about US$10.8 billion, which it could not pay (RaboResearch 2013). To address this challenge, the IMF provided Mexico with US$3.4 billion in exchange for the country substantially cutting its budget deficit and implementing structural reforms (IMF 1983). The commercial banks agreed to extend US$1.5 billion in new financing and to reschedule payments due on US$23 billion of the total debt. In addition, the US government provided US$2 billion in support (RaboResearch 2013).

THE COVID-19 PANDEMIC

The COVID-19 pandemic has had substantial financial consequences. In March 2020, panicked investors withdrew from domestic and international financial markets thereby reducing access to credit for sovereigns, corporations and households. Drawing on the legal authorities and policy toolkits developed during and in the aftermath of the global financial crisis, the major central banks responded swiftly by injecting over US$10 trillion in dollars and other convertible currencies into financial markets, activating swap lines to support select central banks, and, in the case of the Fed, creating a special repo facility for other central banks in need of US dollars and with holdings of US Treasuries. Through these actions, they were able to support commercial banks and other financial institutions such as investment banks, asset management firms, private equity firms, hedge funds, pension funds, insurance companies, money market funds, and sovereign wealth funds. These institutions, in turn, could decide how to allocate the trillions of dollars of additional liquidity among their many sovereign, corporate, and household clients. In fact, year on year, US dollar credit to borrowers outside the US grew by 6% to US$12.7 trillion and credit to borrowers outside the Euro area grew by 4% to Euro 3.5 trillion by end of June 2020 (BIS 2020).

The international financial institutions (IFIs), like the IMF and the World Bank, moved more slowly but also provided support to their member states. However, while central banks pumped trillions into international and national financial markets, IFIs were only able to provide a few hundred billion US dollars. Through 19 April 2021, the IMF provided about US$110 billion to 84 countries in emergency financial support (IMF 2021). The World Bank has committed to extend US$160 billion to its members by June 2021 (World Bank 2021).

This means that during the pandemic, unlike in the 1980s sovereign debt crisis, central banks have played the leading role in supporting financial markets and financial institutions. They, in turn, have determined which states and companies were able to raise funds on financial markets. However, unlike the IMF in 1982, the central banks did not have the mandate to condition access to the financing on it being used to address the global pandemic. This has contributed to international initiatives to deal with the pandemic being less effective than anticipated. To cite one example, one reason that only 47 of the 73 eligible states have asked for support under the G20's Debt Service Suspension Initiative is that financial institutions have implicitly discouraged their debtor states from taking advantage of it.

FACTORS BEHIND THE GROWING INFLUENCE OF CENTRAL BANKS IN GLOBAL FINANCIAL GOVERNANCE

The growing influence of central banks in global financial governance is attributable to two factors. First, finance has become global while regulation and supervision remain national. This means that national monetary and financial authorities are unable to perform their domestic mandates without becoming active participants in the international financial system. Second, the broad range of institutions involved in international finance are supervised by a complex mix of regulatory and supervisory authorities with varying mandates, powers and views of the risks that their regulated entities face.

In response to these two factors, central banks and other national regulatory and supervisory authorities have recognised that they need international standards to guide their activities. They have established forums in which they formulate international regulatory and supervisory standards that they all promise to implement through their domestic laws, rules and regulations. For example, the Basel Committee on Banking Supervision has developed the Core Principles on Banking Supervision to help ensure a certain consistency in banking oversight across the globe. More recently, central banks and financial regulators created the Network for Greening the Financial System (NGFS), which seeks to define and promote best practices that help its members deal with the risks created by climate change. However, the implementation of these principles and best practices are mediated through the mandates of each central bank and regulatory authority and its interpretation of these standards. This inevitably leads to gaps in and between different national regulatory schemes, which global banks and transnational private financial institutions can exploit. This regulatory arbitrage in turn pushes central banks and other national financial authorities into more intensive international engagements.

There are two reasons to believe that the leading role that central banks have played in global financial governance will continue growing. First, the current global financial system is built around national currencies, particularly the US dollar.[2] The US dollar's impact on global financial flows and currency values means that the most significant central banks cannot fully comply with their national mandates without participating in global financial governance. In fact, their incentive to do so is being strengthened by developments in information technologies and their implications for money and credit, payments systems, and the global movement of financial resources.

This can be seen most clearly in the case of the Fed. It is being pushed by its responsibility for protecting the stability of the US dollar to provide swap arrangements and other forms of liquidity support to select central banks. It is also being pushed to collaborate with other central banks and financial regulatory authorities in forums like the Financial Stability Board (FSB) and the NGFS because it cannot be confident of protecting the stability of financial institutions subject to its jurisdiction without knowing that other key jurisdictions are using comparable standards in their supervision of their financial institutions.

Second, it is becoming increasingly clear that monetary and financial stability policies are not environmentally or socially neutral. For example, a 2017 study found that the BoE's purchase of corporate bonds as part of its quantitative easing (QE) program were biased towards carbon intensive sectors (Matikainen et al. 2017). More recently, the National Bank of Belgium was sued based on the allegation that its QE purchases are helping to fuel the climate crisis (White and Randow 2021). As a consequence, central banks are beginning to recognise that they cannot ignore complex social and environmental challenges like climate change in their decision making and operations (Bolton et al. 2020). This, in turn, is likely to draw them even further into playing a role in the governance of the financial and monetary aspects of the most difficult and urgent global problems.

CHALLENGES ARISING FROM THE GROWING INFLUENCE OF CENTRAL BANKS

The growing influence of central banks in global financial governance poses two challenges. The first is operational. Unlike the IFIs, which must utilise their resources to meet their responsibilities to all their member states, central banks are legally required to use their resources both at home and in cross-border operations to fulfil their domestic mandates. When central banks participate in discussions about international financial and monetary affairs, unlike the IFIs, they are motivated to focus primarily on domestic rather than global concerns. Consequently, central banks, in their cross-border activities, tend to allocate their resources to countries and entities that are systemically important or that they view as having a significant impact on their domestic monetary and financial situation rather than to those most in need (Aizenman et al. 2021).

This situation creates a strong bias in the governance of the international monetary and financial system towards the home states of the key central banks and those states of most interest to them. This bias also increases the risk that global financial governance will work to the detriment of poorer and less influential states and will strengthen the existing mal-distributions of power and wealth in the world. It may also adversely affect the sustainability of the global economy and the planet.

The second challenge is identifying the international standards that should guide central banks in their global financial governance decisions and operations. Since most central banks – with some prominent exceptions like the ECB – are created under their home countries' domestic law and are agencies of their respective governments, they are bound by their sovereign's international legal obligations. This means that they must not violate any applicable treaties that their sovereigns have signed or the applicable principles of customary international law that are binding on all states. However, there are few treaties and customary international law principles that deal explicitly with the global financial governance responsibilities of states or are obviously applicable to central banking. Consequently, international law is not particularly helpful in defining the responsibilities and obligations of central banks operating extra-territorially (Bradlow and Park 2020).

In addition, in the event that a central bank did violate any applicable international law, its sovereign, and not the central bank, would be internationally responsible for the resulting harm. This is despite the fact that most central banks have operational independence and so have the authority to decide for themselves what cross-border monetary and financial activities to undertake. Since they are creatures of domestic law, they are only accountable domestically for these decisions and their impacts. This is the case even if their decisions are intended to influence the international financial system or if they cause harm to state and non-state actors outside their home states.

This situation was tolerable as long as central banks only played a limited role in global financial governance. However, their growing influence is making it untenable for them to operate in this area only subject to their home country's laws. As is the case with other global governance institutions, central banks need international standards to guide their decisions and operations that are intended to have cross-border implications.

PROPOSAL

While central bank operations are in many important ways unique, their global financial governance activities are analogous to the activities of other key actors in the global economy. The international community's response to the relevant activities of these other actors can offer insights into how to design international standards for central banks.

The first analogy is to the activities of IFIs that directly, as opposed to through the mediation of the state, affect the citizens of their member states. An example of such activities are the decisions of the World Bank to fund projects that have adverse social and environmental impacts on communities and individuals in its member states. These decisions are solely the responsibility of the World Bank, who thus have some responsibility for their impacts. However, neither its Articles of Agreement nor the applicable international law principles provide sufficient guidance to the World Bank on how to fulfil this responsibility. The World Bank and the other multilateral development banks (MDBs) have responded to this deficiency by developing their own operational policies and procedures. These publicly available polices both inform their staff about how they should implement the banks' mission and establish the benchmarks that can be used to hold the banks accountable for the impacts of their operations. In this sense, these policies are comparable to the standards that guide the activities of national administrative agencies that directly affect the lives and well-being of communities and individuals. This suggests that the IFIs, in developing their own standards, should comply with the general principles of good governance, including transparency, participation, reasoned decision making and accountability, that are applicable to all public authorities. In fact, the IFIs do endeavour to incorporate these principles into their operations.[3]

Second, central banks, in their global governance operations, share some characteristics with the extra-territorial activities of transnational corporations. Like central banks, these companies must comply with all applicable domestic legal requirements. However, their legal obligations whenever their conduct has extraterritorial effects are not always clear or consistent across countries. This can lead to disputes, for example, regarding their responsibilities when their activities affect communities and individuals outside their home jurisdiction or their responsibility for the activities of their suppliers. The international community has responded by developing international standards to inform transnational corporations and their stakeholders about their responsibilities in these extra-territorial activities.[4] These standards include the United Nations Guiding Principles on Business and Human Rights, the OECD Guidelines on Multinational Enterprises, and the OECD Framework on Due Diligence for Responsible Corporate Lending and Securities Underwriting. Pursuant to these standards, transnational corporations should have publicly available policies dealing with the social, environmental and human rights aspects of their operations, and should conduct *ex ante* assessments of the social, environmental and human rights impacts of their operations and decisions. Moreover, they are expected to report on their compliance with these standards or policies.

The lessons learned from these two analogous situations can be applied *mutatis mutandis* in formulating the following international standards to guide central banks as global financial governance actors:

1. *Responsibility to Understand:* Central banks should understand all the economic, financial, monetary, social, environmental and human rights impacts of their decisions and actions that are intended to operate extra-territorially – such as establishing swap lines with other central banks or establishing facilities that are designed to provide liquidity to markets outside their home jurisdictions.
   - Central banks should assess these impacts *ex post,* if, because of the nature of their monetary responsibilities, they are unable to do so before they make or implement monetary policy.
   - Central banks should undertake *ex ante* assessments of the cross-border impacts of all proposed bank regulatory and financial stability actions.
2. *Responsibility to Disclose:* Central banks should prepare regular reports describing the impacts of all decisions intended to operate extraterritorially.
   - Central banks should release an annual report discussing the impacts of their monetary policy decisions that are intended to operate extraterritorially.
   - Central banks should publish an annual report discussing the impacts of their regulatory and financial stability policies and operations that are intended to operate extraterritorially.
3. *Responsibility to Monitor and Learn:* The G20 should request an international body such as the BIS or FSB to establish an independent office to review the global financial governance activities of central banks.
   - In order to protect its independence, this office should be independently financed, determine its own workplan, should make its own independent assessments of the global governance related operations of central banks and should be authorised to make recommendations on how to improve the role of central banks in global financial governance.
   - The office should issue regular reports to the G20 that should be publicly available.
   - This office should establish channels through which interested parties can submit information on the impacts of central bank global monetary and financial governance activities. The office should discuss these communications in its annual report.

The G20 should endorse these recommendations. By doing so, the G20 will promote global monetary and financial governance arrangements that are both responsive to changing global governance realities and consistent with the operational independence and monetary and financial responsibilities of central banks.

NOTES

[1] The global financial crisis of 2007-08, of course, was another historically significant event with important implications for the subsequent governance of financial and monetary affairs, including the international response to the financial and monetary impacts of the COVID-19 pandemic. Given space constraints, this policy brief therefore focuses on the more recent crisis.

[2] For example, in 2019, the US dollar was used in about 80% of inter-currency payments for world trade (D'Antona Jr. 2020). In 2020, the US dollar was on one side of 73% of global daily foreign exchange transactions (Rivero 2020); and in 2020 constituted about 60% of global foreign currency reserves (Siripurapu 2020).

[3] The World Bank's environmental and social framework is a notable example.

[4] States have enacted laws to address these issues such as, for example, the United Kingdom's Modern Slavery Act of 2015 and France's Law on the Corporate Duty of Vigilance of 2017.

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