Financial Crises: The Role of the Private Sector

Statement Presented to the Joint Economic Committee

of the Congress of the United States

by

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March 8, 2001

When is a crisis not a crisis? When it occurs eight times within six years. Now, both semantics and policies must alter.

A year ago, the Meltzer Commission warned that "a mechanism [must be] designed to avoid the abuse of [IMF] liquidity assistance to sponsor bailouts". Fine tuning of the mechanics of present intervention won't accomplish the task. Nor will convivial dialogue or earnest exhortation. We must focus instead on the incentives that motivate behavior. The view of crises has been static and we must move to a dynamic approach that recognizes that an expedient response to one crisis can trigger a spiral of irresponsible borrowing and speculative investing.

Thus far, every move that has been made has acted to create more crises. We have simply socialized the risk and privatized the return. Those who have set the precedent for bailouts have set aside the basics of market economics:

Fact 1: Voluntary participation in crisis resolution is an oxymoron. No one voluntarily takes a loss.

Fact 2: If a high return is offered without the attendant high risk, there will be excess demand.

Fact 3: Only the credible prospect of default can enforce change in countries, write-downs in creditor holdings and caution in capitalists.

There has been no change in official conduct since bailouts entered the international consciousness in 1995 with Mexico. Then, the U.S. Treasury led an intervention effort to gather some $50 billion for what they swore was a one-time event. Afterwards in 1996 the G10 united to promise they would act to "discourage expectations that large-scale official financing packages will be available to meet debt service obligations to the private sector".

There followed in swift succession: in 1997, Thailand for $17 billion, Indonesia for $34 billion and Korea for $57 billion; in 1998, Russia for $16 billion and Brazil for $42 billion; and now Turkey for $10 billion and Argentina for $20 billion. To date, a quarter trillion dollars in debt and risk has been shifted from the balance sheets of private creditors to official ledgers.

Loss has largely bypassed the private sector that, with the exception of Russia, has not written off a single dollar on sovereign lending to large emerging nations. When the international financial institutions move in and shore up the credit of faltering economies, private sector lending on terms the market sets after the bailout is simply an arms-length decision. This cannot be confounded with the *bona fide* participation that implies a cooperative sharing of cost and risk.

Political outcry in the industrialized world continues to demand that those who garner high returns must be compelled to contribute to emergency solutions. The paradox is that the private sector was already "bailed in" until we elected to bail them out.

The IMF response thus far has been long on subterfuge and short on substance. A case in point is Argentina where the Fund is boasting private sector participation for half of the $40 billion emergency package. In truth, it is nothing more than a bonus for bad lending decisions. Investors took no losses, assumed no risk and proffered no concessions on new funding.

All the evidence points to a new multilateral policy that has crystallized without legislative accord: a high flow of affordable funding to emerging economies, far beyond what official capability can provide, must be encouraged at all cost. The shadow of contagion has been stretched with each episode and, now with Turkey, to the view that default in any major emerging nation will shake investor confidence in all. Fear of global disruption provides an expedient bugaboo, but it is no longer the prime motive for intervention.

IMF behavior implies a blanket guaranty backed by the G7 governments that appears to eliminate virtually all investor risk and awaits the advent of the deluge to cry crisis and justify emergency aid. But there are consequences. Flows will become excessive as speculation escalates, governments become profligate, domestic entrepreneurs overextend and foreign investment is ill-considered. Without the stabilizing discipline of natural market forces, incentives for emerging nations to fulfill promises of reform are destroyed, economic growth is subverted and the population at large is shortchanged. Ahead lies the time when the totality of this new Ponzi scheme could entrain a worldwide crisis that engulfs the donors along with the recipients.

No one questions that growth and prosperity in developing countries are in the interest of every member of the system, but less reckless and less costly means must be explored. In times of calm, not in the midst of calamity, we must put in place a new framework and new tools that draw upon the skills and vast resources of the capital markets.

We must recognize that developing countries, with their violent political and economic swings, are sources of recurring disturbance. Undisciplined capital flows, emboldened by implicit IMF insurance, magnify this risk. The only unknowns are when and where instability will arise.

We must identify systemic economies, whose weakness might spread beyond their borders. For the IMF, as lender of last resort, true responsibility is to the system not to individual borrowers. Today, perhaps five economies in the emerging world would qualify: Argentina, Brazil, China, Korea and Mexico. For this critical universe, the IMF should subsidize the cost of stability as a global public good.

We must divorce the resolution of pre-crisis debt from the provision of new financing and direct these functions to different segments of the financial markets. The flow of emergency resources must not be obstructed by the renegotiation of old claims and new funds must be sequestered to forestall diversion into the payment of past obligations.

We must prepare reservoirs of liquidity for the times when credit weakens, but on terms negotiated before the event. Short maturity bridge funds offer breathing room that permits borrowers to restructure outstanding debt and to seek long term financing from both the capital markets and the development banks for genuine structural reform.

There is a new direction to explore that addresses all these needs. It provides preparedness, liquidity for core economies, segregation of new funds and real private sector participation. A summary of the new structure follows, while a detailed outline is included as an appendix to this testimony.

The stand-by credit line to provide emergency liquidity is ubiquitous in the marketplace. But, it can be transformed to become tradeable, securitized, subsidized by the IMF and protected by the Fund's endorsement of borrower policies. By this means, the IMF can enlist the private sector to assume the risk of threatened economies in advance and compensate the markets to provide an automatic first line of defense. The Fund retains its traditional role of lender of last resort.

Options and notes, both publicly traded, are mechanisms that can modernize the classic stand-by line. Put options would give the IMF the ability to sell to private sector institutions at any time, over a predetermined medium term period, floating rate notes issued by the core emerging governments.

Risk is diminished for the private sector by conditions on the exercise of the options and the release of the funds--either agreement to an IMF-sanctioned adjustment program or fulfillment of the preconditions of an IMF Contingent Credit Line (CCL). But, the risk is not transferred to the taxpayers of the Fund's creditor members as occurs in classic IMF intervention.

A securitized, liquid marketplace will attract a spectrum of institutions beyond the traditional commercial bank universe that has dominated contingent credit lines in the past. Every quarter, the IMF would buy, through competitive tender, 1 year put options covering $1 billion principal amount of underlying notes for each country and 3 year put options covering $500 million principal amount of underlying notes for each country. After 3 years, this new source of emergency financing would generate a sum equal to half the IMF's effective available resources--$50 billion or $10 billion for each of the core emerging economies--reducing the demand for future quota increases.

The cost of the contingency structure will become ever more competitive as the market develops. Currently, this amounts to 0.35-3.00% per annum depending upon the borrowing country.

Since global financial stability is a prime public good, all members of the world economy should contribute. The cost of a $50 billion program for the five core emerging economies would be approximately $750 million per annum, divided equally between an IMF subsidy and the protected country. To ensure a fair distribution of the Fund's share of costs among its creditor and debtor members, financing could be generated by raising the rate of charge on all loans and lowering the rate of remuneration on credit balances of donor nations. The effective annual cost to the creditor members would be $187.5 million of which the U.S. would bear $50-60 million.

Today, the IMF is engaged in a process of continuous intervention providing emergency resources to some 30 countries. Should market-based contingent financing expand to serve a broader spectrum of IMF members and grow to provision $100 billion or more of funds, there may come a time when Fund lending will become redundant. This would redefine the institution as a stalwart lender of last resort, ever vigilant but seldom in action.

Appendix

Securitized Contingent Financing: A Means to Bail-in the Private Sector

I. Strategy

The IMF has long been seeking a means to integrate private sector investors in emergency financing. Past approaches have faltered because they have relied on coercion of pre-crisis lenders after the fact rather than on voluntary participation of highly developed capital markets before the event. This strategy looks back to the 1980's when official funds dominated developing economy finance and a cohesive group of commercial bank lenders controlled private sector flows. Then, moral suasion by industrialized governments forced regulated financial institutions to roll-over loans and to extend new credit lines.

Coercion is not viable in a world of highly mobile capital dominated by unregulated intermediaries. A new strategy is needed that takes advantage of the sophistication of the financial markets in advance and recognizes that the provision of new emergency resources must be divorced from the restructuring of pre-crisis debt. The offer of new funds on terms that the market sets after official intervention is simply an arms-length economic decision. True participation implies sharing the cost and assuming the risk.

The core responsibility of the Fund is to act as lender of last resort for the emerging economies. But this obligation is to the global market, not to individual borrowers. Only 5 developing countries are presently large enough to pose a potential risk to the international system: Argentina, Brazil, China, Korea and Mexico. As other nations gain importance, the list will grow. By narrowing its focus to the stability of a core group, the IMF can take the initiative to promote the development of a market-based framework that engages the private sector in crisis financing. Since financial stability is a global public good, IMF subsidization of costs is justified.

In a domestic context, large banks are accorded preferential treatment as “too big to fail”. In the emotional climate of international opinion, current Fund policy that discriminates between the needs of large and small nations is not tenable. Whether it makes economic sense or not, all must be afforded the same opportunities.

II. A New Structure: Securitized Contingent Financing

The stand-by credit line to provide emergency liquidity is a commonplace tool. But, it can be transformed by a new market-based framework to become tradeable and securitized, subsidized by the IMF and protected by the Fund’s endorsement of borrower policies. The private sector will be enlisted to assume the risk of threatened economies in advance and compensated to provide an automatic first line of defense against those major crises that might entrain contagion.

The IMF would purchase put options from qualifying private sector institutions that give the Fund the ability to sell at any time, over a predetermined medium term period, floating rate notes issued by the 5 core emerging governments at the moment of crisis. When issued, the notes would have a short maturity, carry a high floating interest rate (penalty rate) and be publicly traded. These terms, combined with the large size of the issues, will ensure their liquidity.

Because the provision of liquidity is the objective, a short 1 year maturity of the financing, when drawn, is appropriate. This will provide bridge funds that permit the crisis borrower to restructure its outstanding debt, if necessary, and to obtain long term financing both from the capital markets and from the development banks for structural adjustment programs.

The only condition on the exercise of the options would be agreement to an IMF-sanctioned adjustment program or fulfillment of the preconditions of an IMF Contingent Credit Line (CCL). There is no requirement of official financing. This positions the private sector as the first line of defense in financial crises with the Fund retaining its role of lender of last resort to emerging economies if contagion threatens.

A different series of options would be created for each of the systemically important developing economies. The alternate of a composite option on a basket of the borrowers would reduce the potential universe of sellers and increase the cost. Smaller programs would be tailored to the needs of other nations that elect to participate.

Standard lender of last resort terms should apply: penalty interest rate, short maturity and a high level of protection. An example: total principal amount of underlying notes per borrower: $10 billion; life of put options: 1-3 years; term of underlying notes: 1 year;

interest rate on notes: 3 month Libor + 7%; minimum denomination of option: $10 million principal amount of underlying notes.

The condition of an adjustment program or fulfillment of CCL requirements ensures protection for private sector participants because the borrower will have agreed to meet IMF economic policy conditions or already satisfied preconditions before the option can be exercised and funds released. This mitigates the risk for the private lenders without transferring it to the taxpayers of the Fund's creditor members. In addition, it decreases the probability that the borrowers will simply reduce the level of their reserve assets and unconditional private sector lines of credit annulling the stand-by protection.

III. Issuance, Credit Risk, Transferability and Liquidity

A staggered offering schedule will smooth absorption and protect against times of crisis when markets are effectively closed. Every quarter, the IMF would buy, through competitive tender, 1 year put options covering $1,000 million principal amount of underlying notes for each country and 3 year put options covering $500 million principal amount of underlying notes for each country. Since only 15% of the options will be rolled over at any given auction, at least 85% of contingent financing will be always at hand, permitting postponement of bidding until functioning markets are restored. After 3 years, this new source of emergency financing would generate a sum equal to half the IMF's effective available resources--$50 billion or $10 billion for each of the core emerging economies.

Sellers of the options would be based in industrialized countries and meet qualifying criteria to minimize counterparty risk. These would include: minimum long-term ratings of A, minimum asset levels and maximum levels of options written in relation to capital. Among qualifying institutions, the options would be freely assignable in minimum denominations of $10 million principal amount of underlying notes. Options would be exercised on a pro rata basis within each option class and the underlying notes, when issued, would be exchange-listed and freely tradable in standard market denominations. All notes issued on the same date would be identical, regardless of the option class, to ensure maximum liquidity.

IV. Option Exercise and Coordination with IMF Intervention

As soon as a core emerging country agrees to an IMF economic adjustment program or fulfills the preconditions under a CCL, the Fund would have the ability to draw immediately upon private sector lenders for emergency financing. Mechanically, at the time of intervention, the crisis country would issue notes to the Fund and the Fund would exercise its option to sell the notes to the current option counterparties at 100% of principal amount. The proceeds of the note sale would be transferred from the IMF to the borrowing nation.

Even when a country is in default under existing liabilities, the proposed mechanism functions without danger of the attachment of the new funds by old creditors. The option contracts run between the IMF, not the crisis borrower, and the contingent lenders and IMF disbursements are exempt from attachment under sovereign immunity law. There is no credit exposure for the Fund in its pure pass-through function.

If the Fund provides financing, in tandem with the proposed contingent facility, equal creditor rank for the Fund and the private lenders would not be implied. Private sector institutions would have market standing and would not benefit from the IMF's preferred creditor status.

V. Building a Liquid Market

A stand-by facility that is both marketable and securitized will attract capital and lower costs. By establishing an ongoing substantial demand, the IMF will precipitate a supply response and promote the development of the market. A securitized, liquid marketplace will attract a spectrum of institutions beyond the traditional commercial bank universe.

In the syndicated loan market, the cost of this type of facility is 0.35-2.75% per annum. In the nascent credit derivative market, the cost of the put options would be 1.50-3.00% for the 1 year options and 1.00-2.10% per annum for the 3 year options depending upon the borrowing country. (See attached table of Cost of Contingent Financing.)

Currently proposed regulations and accounting reforms advanced under the Basle Committee on Banking Supervision and the Financial Accounting Standards Board and the International Accounting Standards Committee will drive convergence of the two markets toward uniform pricing and increase the importance of liquidity. Mark to market, or fair value accounting, of all financial assets will force commercial banks to price loans on true economic terms or face immediate earnings and balance sheet losses.

New capital adequacy standards will promote consistency between banking book and trading book treatments and eliminate incentives for regulatory capital arbitrage.

Effective pricing will be assured by a competitive universe of participants, comprised of the 10 commercial banks that lead the syndicated loan business and the 7 major financial institutions that make markets in emerging economy credit and spread risk through derivatives. For these last, growth is constrained by the availability of instruments for the option sellers' hedging mechanisms. This is particularly severe in the case of China which has not issued substantial amounts of foreign-currency denominated debt and has tightly controlled foreign exchange and domestic financial markets. Over time, the 5 core developing economies will continue to increase the supply of their debt instruments and liberalize their domestic capital and foreign exchange markets. This will augment the capacity of the derivatives market to hedge and hence to offer and trade the options.

VI. Funding the Cost of the Options

Global financial stability is a public good whose cost should be shared by all who benefit from prosperity in the world economy. This justifies IMF subsidization with option premiums divided equally between the Fund and the country receiving the stand-by protection. To ensure a fair distribution of the IMF's share of costs among its creditor and debtor members, financing would come from raising the rate of charge on all loans and lowering the rate of remuneration on credit balances of donor nations. Adjustments to each of 0.25-0.35% per annum will cover the initial 5 core economies. This is a small price to engage the private sector and to leverage IMF resources on a significant scale.

Cost of Private Sector Contingent Financing *

	Commercial Bank Stand-By	Credit Derivatives	
Life of facility/option	3 yr.	1 yr.	3 yr.
Term of financing upon exercise	Up to 3 yr.	1 yr.	1 yr.
Argentina			
Interest rate	Libor + 3%	Libor + 7%	
Annual commitment fee/ option premium	2.75%	3.00%	2.10%
Brazil			
Interest rate	Libor + 2.75%	Libor + 7%	
Annual commitment fee/ option premium	2.25%	2.95%	2.05%
Mexico			
Interest rate	Libor + 0.875%	Libor + 7%	
Annual commitment fee/ option premium	0.50%	1.75%	1.20%
China			
Interest rate	Libor + 0.50%	Libor + 7%	
Annual commitment fee/ option premium	0.35%	1.50%	1.00%
Korea			
Interest rate	Libor + 0.70%	Libor + 7%	
Annual commitment fee/ option premium	0.50%	1.50%	1.00%

*Pre-Argentina intervention.

Sources: Credit Suisse First Boston
International Finance Corporation