Country insurance: From global to regional

Eduardo Levy Yeyati
UTDT / Brookings / CIPPEC

The priors

- Systemic (global) shocks
  - Balance-sheet concerns may no longer be an issue…but financial recoupling and excessive FX volatility still are.
  - Co-movement severely limits the risk pooling / diversification margin of centralized liquidity provision
- Current liquidity insurance schemes are useful but inadequate
- Reserves are here to stay: They reflect leaning-against-the-wind FX intervention, and are not that costly after all.

The principles

- Bagehot's (1873) LLR:
  - Lend large amounts automatically (on demand) against marketable collateral at penalty rates w.r.t. to normal times…
- Country insurance as ILLR → No collateral
  - *Large*: Sufficient to meet short-term financial obligations and avoid a collapse…
  - *Automatic*: Non discretionary financial assistance according to pre-set eligibility conditions, at a penalty relative to normal (program?) rates.

The Issuer of Last Resort (ILR)

- The domestic LLR is the **Issuer of Last Resort** (ILR)
  - Ensures credibility
  - Avoids carrying costs
- In the context of a global crisis, ILR are hard to find (Fed, BoJ, ECB, China?)
  - A CIS adds value (relative to reserves) if it can leverage on the liquidity created by ILR
- Ultimately, any CIS would reflect how and to what extent the ILR choose to channel their assistance

Moral Hazard (a digression)

- Unlike an insurance policy (which implies a transfer), an ILLR lends.
- To the extent that the ILLR ensures repayment, there is no transfer to the country, and therefore no moral hazard, since the country has nothing to gain at the expense of the ILLR → **It's all about credit risk.**
  - There may be a case for government moral hazard, as the government exploits the ILLR option and leaves the debt burden for the successor…at the expense of the country (not the ILLR).

The new IMF acronyms

- PCL → Extends outreach, under tighter conditions, to non FCL-countries (a lite HAPA?).
- GSM → Addresses FCL-eligible but indifferent countries in a crisis context:
  - Automatic FCL for “systemic” countries (Br, Mx, SK)
  - SLL: Crisis-contingent FCL upgrades for PCL countries
  - Drawbacks → Uncertain activation; no automatic facility for non-systemic countries
  - Would things have been different with the GSM?
- **This is probably as far as the IMF can go.**

Where do we go from here? Goldilocks

- The G20 stays close to the LLR blueprint → **Multilateral CB swap network**:
  - The IMF as facilitator/manager
    - Purely technical advice (as in the G20 framework) to mitigate the IMF political stigma
    - Explicit ex ante qualification through Article IV consultations
  - A CMI without the reserve pool
- Complementary to reserves (first line of defense) and regional arrangements if any (second line of defense).
- Not for everyone but more inclusive and predictable than what the IMF has to offer on its own.

Where do we go from here? Reform fatigue

- London’s momentum fades, the G20 salutes the GSM and declare victory
- More reserves (first line of defense)
  - It’s not about liquidity, but about procyclical capital flows, asset overshooting, financial recoupling and sudden reversals…but the result is the same: more FX intervention and reserves.
- From global to regional arrangements

Country insurance: From global to regional

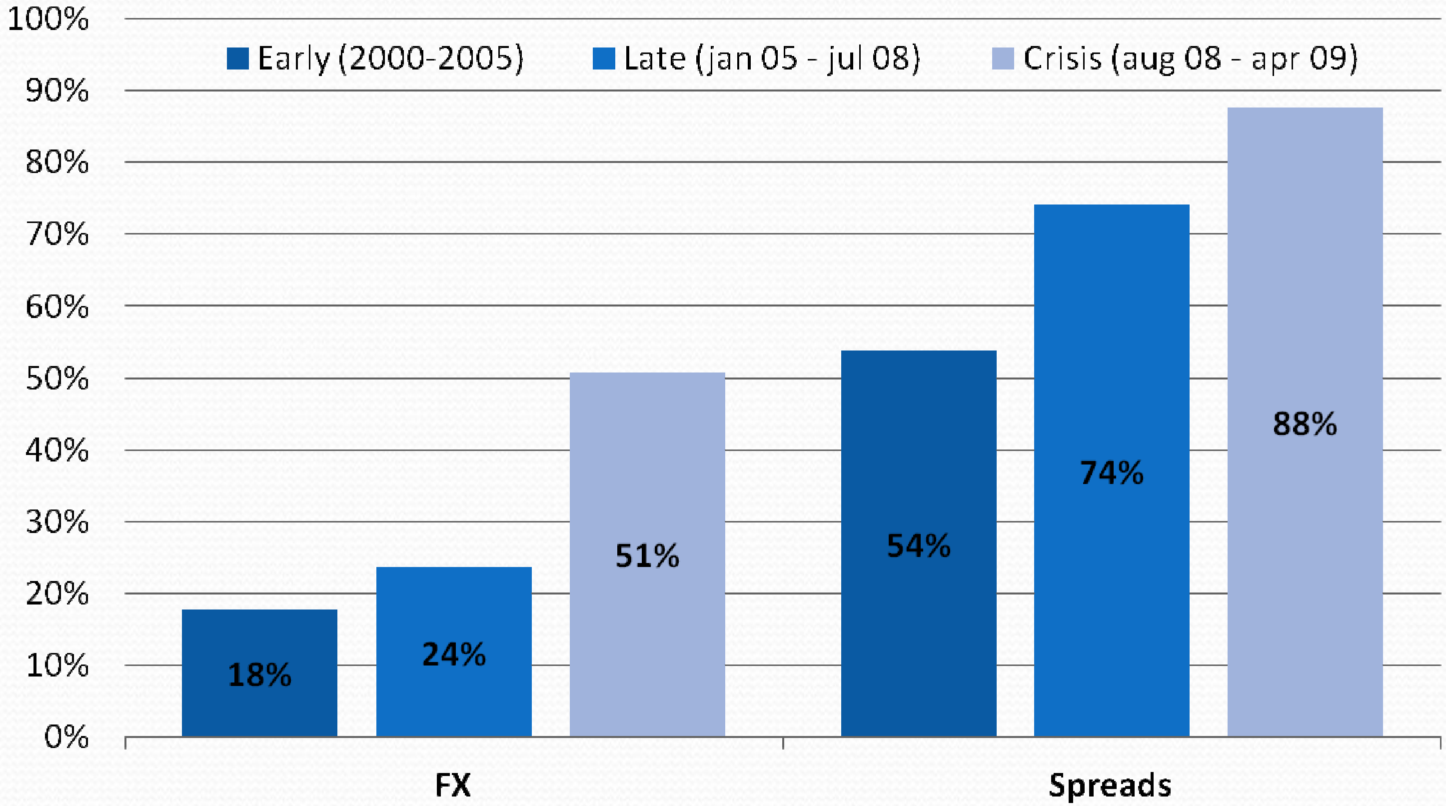
- On the impossiblity of a global CIS
  - Sovereignity and the IMF as a middleman
- Enhanced regional arrangements
  - CMI/AMF & ECB as vehicles for the ILR
  - The limits of peer control and implicit seniority
- Odd man out: Latin America
  - No ILR: limited by correlation risk
  - Is peer control enough to lower carrying costs?
    - FLAR, CAF: spreads at low volumes
    - Can FLAR engage the Fed?

Thank you

Figures

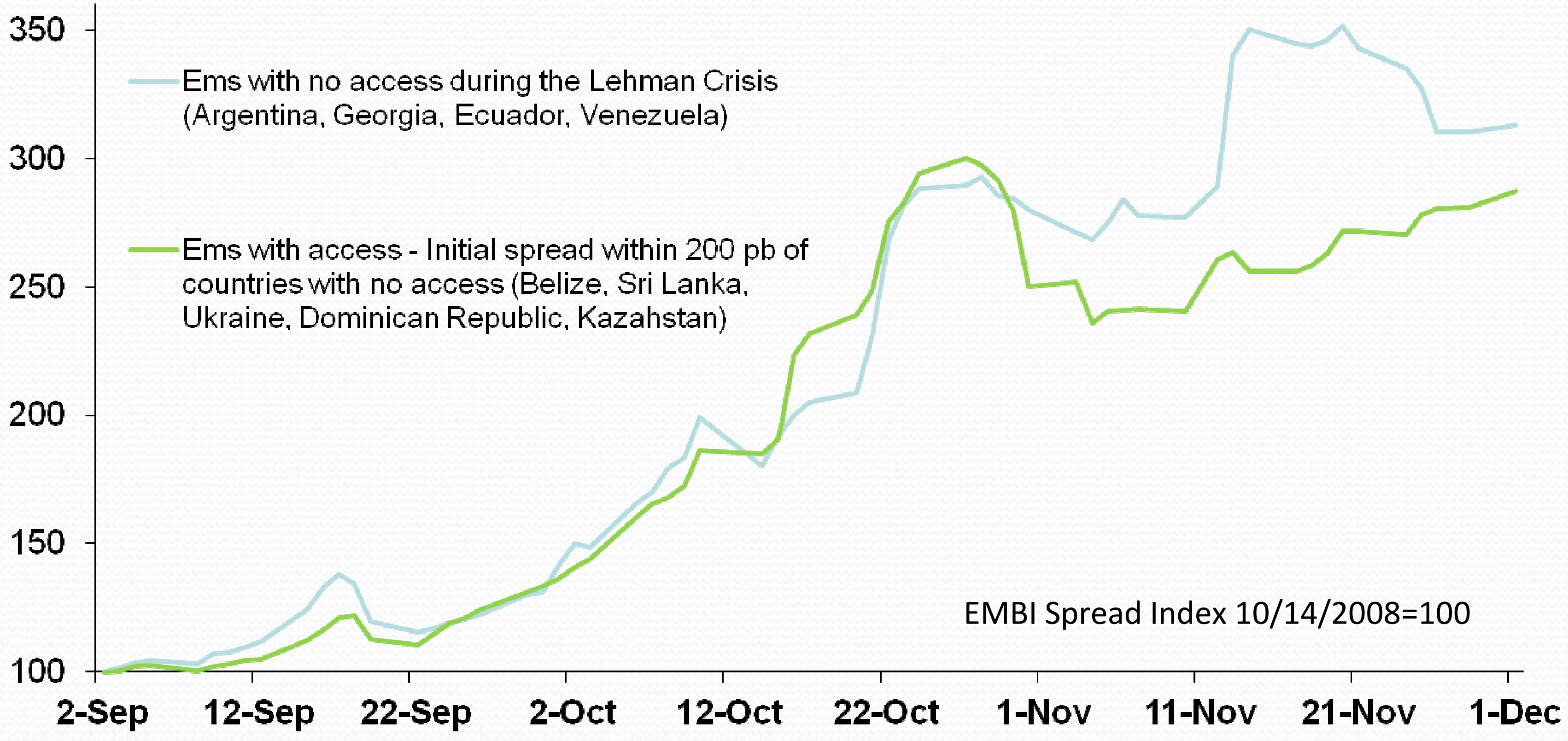
Limited diversification margin

- FX and CDS spread variance explained by 1st PC



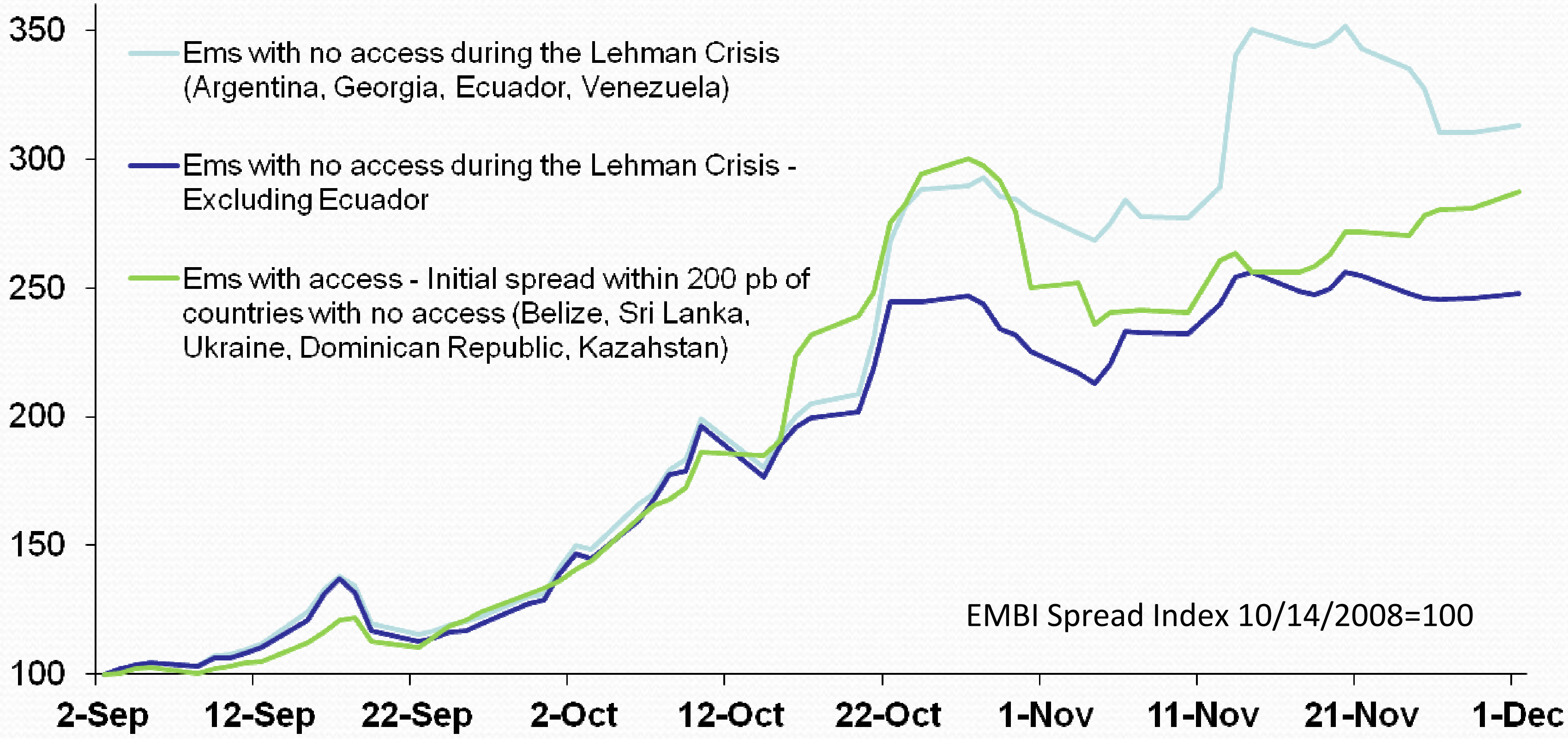
Source: Bloomberg, Author's calculations.

Current safety nets - Lehman



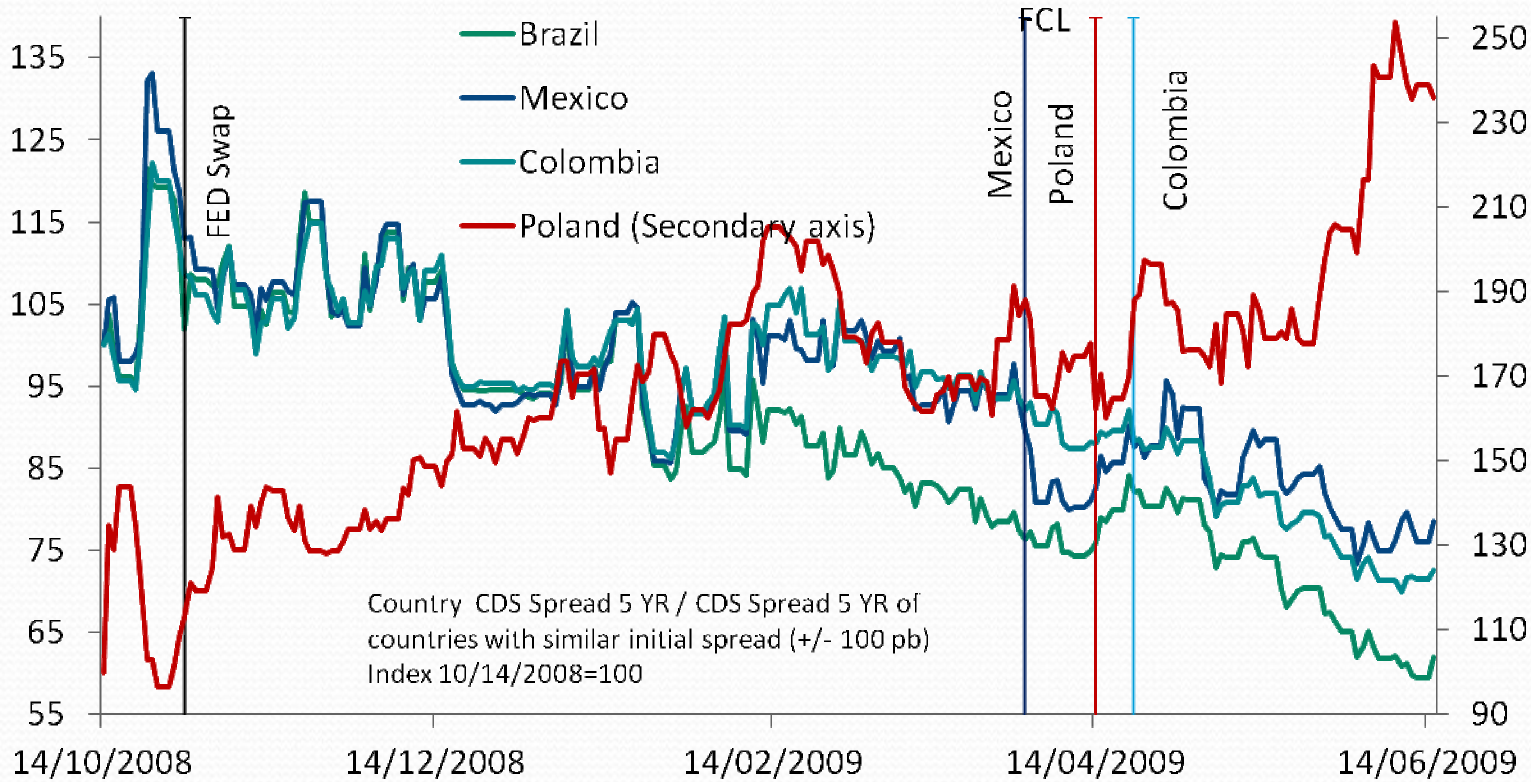
Source: IFS, authors' calculations.

Current safety nets - Lehman



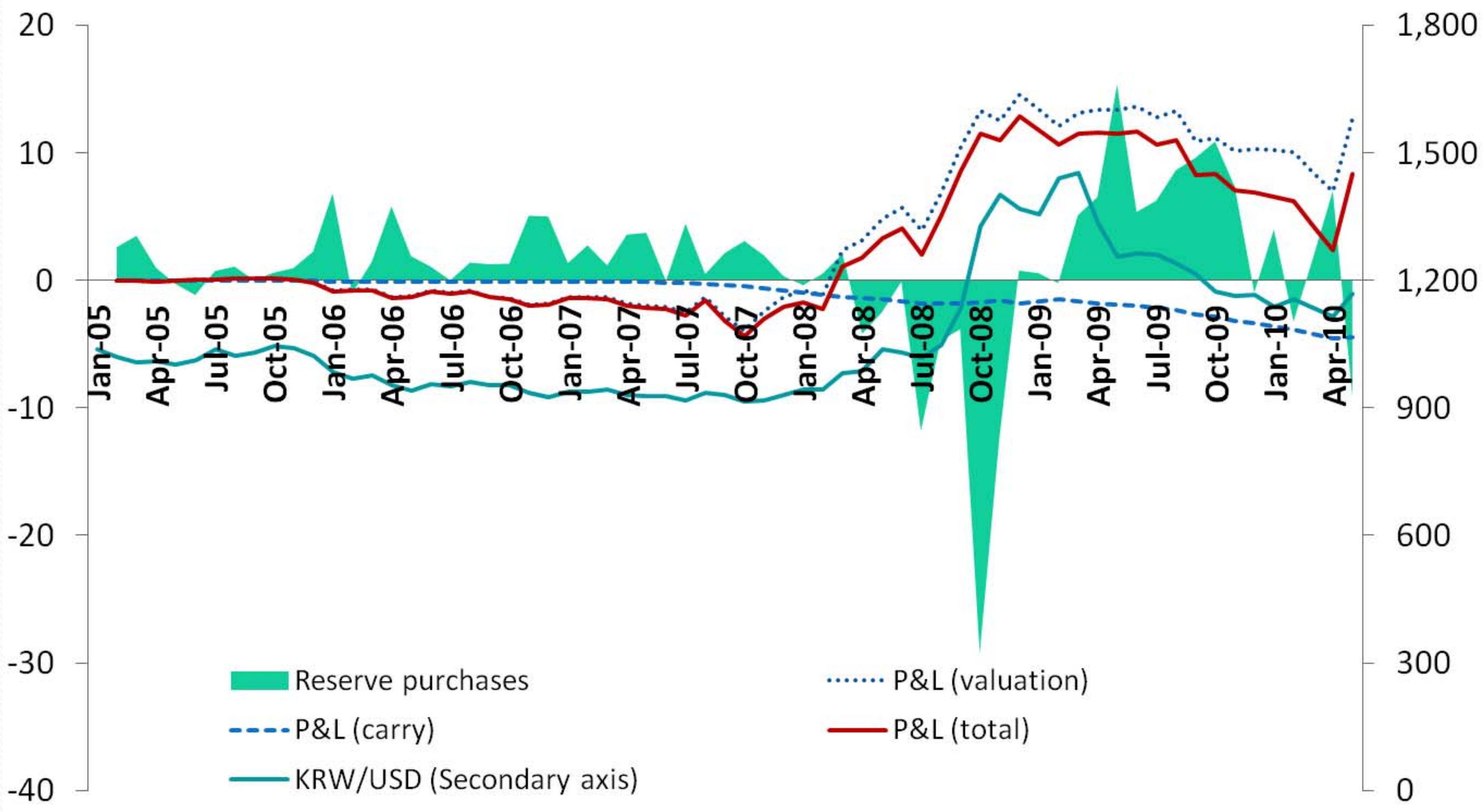
Source: IFS, authors' calculations.

Current safety nets – Fed swaps & FCL

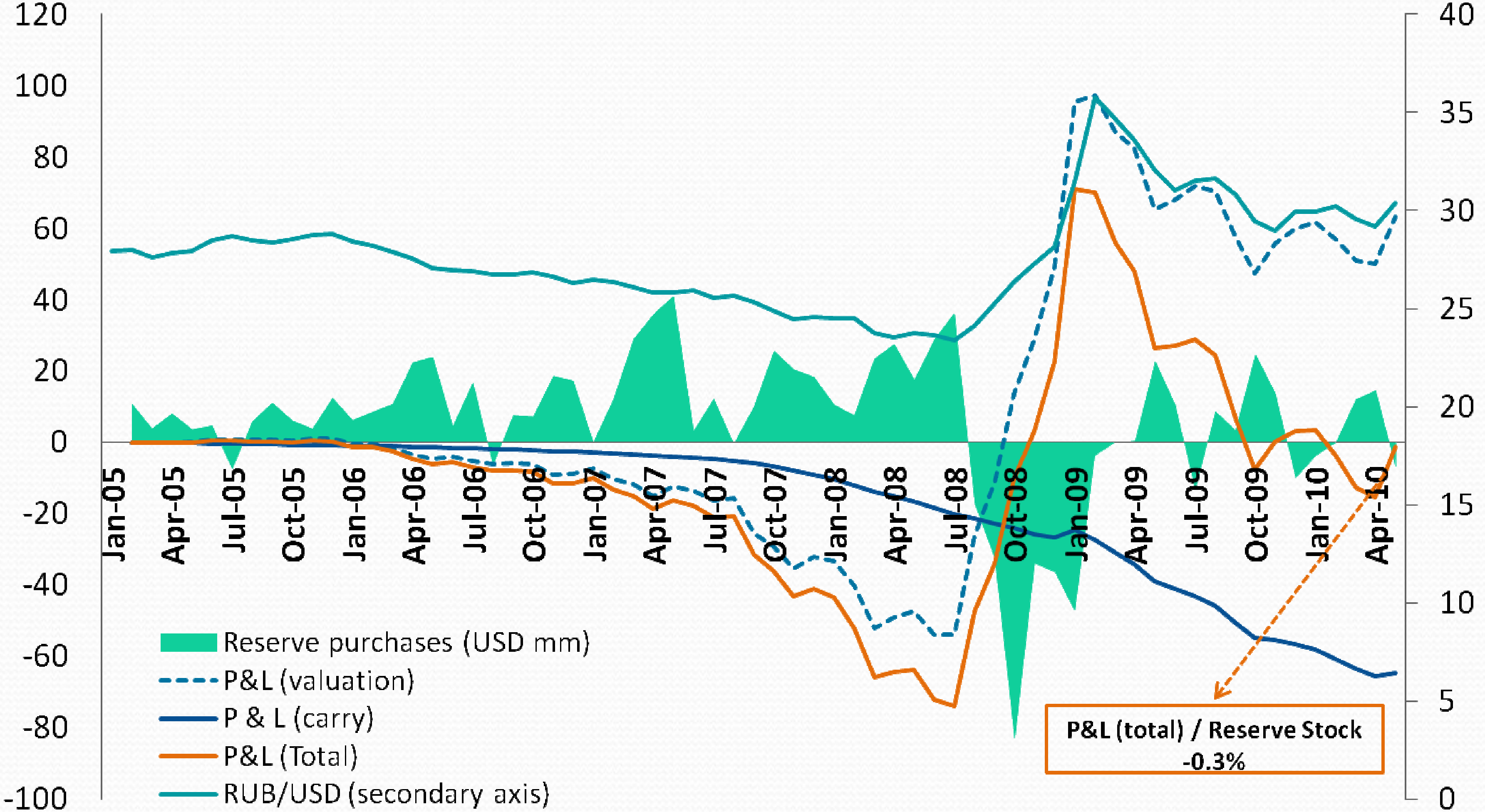


Brazil (controls): Serbia, El Salvador, Peru, Panama, South Africa, Hungary, Phillippines, Vietnam.
Mexico (controls): Chile, Malaysia, Serbia, El Salvador, Panama, Peru, South Africa, Hungary.
Colombia (controls): Serbia, El Salvador, Peru, Panama, South Africa, Hungary, Phillippines.
Poland (controls): China, Chile, Malaysia.

Leaning against the wind - Korea



Leaning against the wind - Russia



Leaning against the wind - Mexico