



# Mitigating risks in the international financial system: national, regional, global responses

## *New precautionary lending and its potential impact on reserve accumulation*

Joshua Aizenman  
UCSC and the NBER  
September 2010



*ROAD TO SEOUL*

## ***New precautionary lending and its potential impact on reserve accumulation***



- In the short-intermediate run, the new facilities would have only modest effects on IR accumulation.

### ***Reasons:***

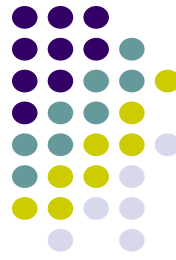
- No simple ways to avoid stigma and moral hazard (MH) effects.
- Good (or bad) reputation is the outcome of time consuming learning.
- How enduring is the new stance of the IMF? How would the IMF function in another crisis of the 1990s type, not propagated from and by the US? Premature to say...

# ***New precautionary lending and its potential impact on reserve accumulation, cont.***



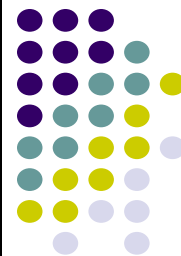
- The new regime would have significant effects only after passing the test of fire.
  - Regional facilities and the swap lines did not pass this test in the present crisis.
  - The IMF has functioned significantly better than in the 1997 crisis, but this crisis was not a 1997 type of an event...
- The future governance structure of the IMF and the durability of the new facilities and their actual implementation remains a work in progress, untested yet in new crises.

# GLOBAL RESPONSES: deeper IMF credit lines would help, but..



- Example: The US financial melt down was an exogenous event from the perspective of Korea.
- *A good idea*: IMF's "precautionary" credit line triggered with minimal strings attached to cover x % of international trade would help, alleviating pressure associated with collapsing trade credit, with no stigma attached.
- *A bad idea due to MH*: IMF's "precautionary" credit line triggered with minimal strings attached to cover x% of the short term external debt.

# The IMF as the friend for a global rainy day



- **Global financial intermediation in rainy global day:** channeling resources to countries that may benefit from conditionality and supervision: from the ECB to some Eastern European countries, etc...
- Automatic swap lines initiated following a global meltdown, linked to pre-crisis volume of trade, would help.
- Mitigation of *Beggar-Thy-Neighbor* policies would help (mitigating competitive depreciations, reducing global imbalances).

# Regional Responses

## Example: Pooling IR via Swap arrangements under the Chiang Mai Initiative (as of 12.2008)



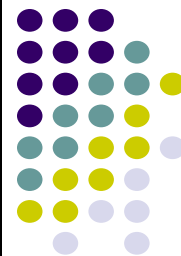
<b>From To</b>	<b>China</b>	<b>Japan</b>	<b>Korea</b>	<b>Indonesia</b>	<b>Malaysia</b>	<b>Philippines</b>	<b>Singapore</b>	<b>Thailand</b>	<b>Total</b>
China		3.0	4.0	4.0	1.5	2.0		2.0	16.5
Japan	3.0		13.0	6.0	1.0	6.0	3.0	6.0	38.0
Korea	4.0	8.0		2.0	1.5	2.0		1.0	18.5
Indonesia			2.0						2.0
Malaysia			1.5						1.5
Philippines		0.5	2.0						2.5
Singapore		1.0							1.0
Thailand		3.0	1.0					..	4.0
Cambodia									0.0
Lao PDR									0.0
Myanmar									0.0
Vietnam									0.0
<b>Sub-total</b>	<b>7.0</b>	<b>15.5</b>	<b>23.5</b>	<b>12.0</b>	<b>4.0</b>	<b>10.0</b>	<b>3.0</b>	<b>9.0</b>	<b>84.0</b>
<b>ASEAN Swap Agreement (among the 10 ASEAN countries)</b>									<b>2.0</b>
<b>TOTAL</b>									<b>86.0</b>

Source: Elaborations based on Japan's Ministry of Finance website.

Available from: <http://www.mof.go.jp/english/index.htm>. Accessed: February 2009.

## Regional Responses, cont.

### A puzzle in Asia's FX reserve management in the global crisis: the virtual invisibility of the Chiang Mai Initiative (CMI).



- It was the type of financial turbulence experienced by Korea in 2008 that the architects of CMI had in mind.
- However, Korea turned to the US Fed for primary support when push came to shove. **Stigma effects** associated with CMI were, apparently, higher than using FED's swap lines.
- Even key CMI partners [PBOC & BoJ] played only a secondary role and outside the CMI framework.
- **Moral hazard remains a key concern:** What is needed is a concrete governance structure and implementation details:
  - How withdrawal requests will be evaluated,
  - How funds will be disbursed.
- The global financial crisis may serve as a catalyst for upgrading CMI, but don't hold your breath for CMI upgrade... Aizenman, Jinjark and Park, NBER WP 15804

**National Responses The demand for International Reserves (IR) is inherently linked to uncertainty and volatility**



- Meeting the demand for IR should deal with challenges associated with local and global rainy days.
  - EMs will keep hoarding large IR to deal with exposure to sudden stops, deleveraging crises.
- “The shortest period of time lies between the minute you put some money away for a rainy day and the unexpected arrival of rain” [Jane Bryant Quinn].*
- Countries with lower balance sheet exposure,  $[\text{STD} / \text{IR} - 1]$ , performed better during the crisis: lower EMP, and greater ability to depreciate without significant balance sheet costs.

# No end to EMs' demand for IR, Room for external debt management



- The 2008-9 crisis: hoarding IR is a potent self-insurance mechanism.
- Yet, hoarding IR is expensive and less efficient in the absence of active external debt management policies.
- Example: 250B IR in Korea, early 08, were not enough to stabilize, fear of using IR during the crisis.
- Congestion externalities call for a Pigovian external borrowing-tax cum hoarding IR-subsidy scheme.
- **These policies reduce the social cost and the scale of IR; co-funding IR hoarding by the activities that expose the economy to the need to self-insure.**
- **Akin to FDIC's risk premia**
- Aizenman, NBER WP 15484, Aizenman and Sun, NBER WP 15308

# Such a policy deals with various distortions



- I. **Moral Hazard:** external borrowing by banks increased the probability of B. of Korea bailout, financed by Korean tax payer, yet borrowers fail to internalize the cost imposed on the tax payer.
- II. **Arbitrage has been globalized, while the tax base remains national.** Foreign banks branches operating in Korea, financed carry trade by increasing their ST external debt, failed to internalize the implications of their borrowing on Korean's tax payers exposure.

Jeong YS. (2009) "Analysis of Korea's Foreign Debt Structure and Implications," October 2009 SERI Quarterly, 43-50.

# Alternatives to self insurance via IR?



## Swap lines and SWF, not a panacea

- A deeper use of swap lines; works only if it's in the interest of the supplying party. Selectivity based on balance sheet exposure of the swap lines providers [see US FED swap lines, Aizenman & Pasricha NBER WP # 14821].
- Channeling IR above a threshold into potentially higher yielding but riskier assets, probably managed by SWFs
  - Helps in reducing the long run costs of IR, but SWF's value tends to drop when you need it...
  - Works for HK and countries with very high IR/GDP.

# Concluding remarks



- The 2008-9 crisis was quite a unique event from the point of view of EMs (the epic-center of the crisis was the US).
- IR hoarding: self-insurance dealing with local and global events.
- It's not clear how the new facilities will function in crises of the 1990s type.
- Don't expect major changes in the patterns of hoarding IR (short of deeper use of SWFs), until the new arrangements pass the test of future crises.

# *Thanks for your attention*

