



Delivering the FSN proposal: National, Regional, Global Responses

Eduardo Fernández-Arias
(personal views)

Reinventing Bretton Woods
Washington, September 2010



1. Financial safety nets for Global Finance: Where we are and where we need to be

- Increasing need for International Lending of Last Resort (ILLR) to deal with country financial crises as financial globalization deepens and spreads
- The international financial safety net to protect against liquidity and solvency crises has holes
- However, after a very slow progress, there are at last some successful new facilities to build on and new multilateral momentum to ride on!

Problems of ILLR for Sovereign Financial Crises

- We know what to do in a liquidity crisis (pour liquidity) but we don't know how to distinguish it from a solvency crisis and are afraid of moral hazard
- We (pretend to?) know how to structure adjustment lending for countries to regain solvency but are afraid countries will not agree and follow through
- We don't know what to do if debt restructuring is needed (no multilateral framework for resolution)
- And situations evolve, morphing liquidity crises into solvency crises needing adjustment...or restructuring

The financial safety net we need

- We need a system of ILLR ready to address liquidity and solvency crises in a robust and coherent fashion across a wide array of countries
- It involves global, regional and national actors
- The following ideas exemplify such system. More details in *International Lending of Last Resort and Sovereign Debt Restructuring* (forthcoming in WB book *Sovereign Debt and the Financial Crisis: Will This Time Be Different?*)

2. A modest proposal: Supporting and building on IMF New Facilities

- Principle: Adapt domestic institutions (liquidity back up, bankruptcy process)
- Objective: Best and widest protection tailored to financial need and country capacity
- Specialized facilities structured to address specific shocks, with prior eligibility and up-front support
- Tiered structure catering to countries' capacities
- Looks complex, but all-purpose, one-size-fits-all facilities are bound to be too selective or too weak

The design of a feasible ILLR is very constrained

- For effectiveness needs to achieve a lot:
 - **Power**: critical mass to restore/keep confidence
 - **Speed**: automatic delivery (avoid Humpty Dumpty fall)
 - **Certainty**: No fine print or last-minute activation clause
- But it lacks traditional instruments of LLR:
 - No collateral: Financial safeguards
 - No regulation: Prudential conditions for eligibility
 - No bankruptcy court to enforce workout: Carrots and sticks to enforce conditions on stakeholders



Basic design principles of a feasible ILLR facility

- **Prior country selection** based on **preset eligibility conditions** of financial safety and economic health with simple standards applicable to specific facility:
 - Soundness of Fundamentals
 - Quality and stability of Policy Framework
- **Country prequalification** with no commitment fee to avoid stigma and adverse selection
- **Ex-post conditionality** on adjustment/reform and debt restructuring **only as needed** to restore solvency
- **Tiers:** Calibrate eligibility standards and extent of conditionality to countries' capacities

Example A: Systemic Liquidity Facility

- **Triggered by widespread liquidity crunch** as in widespread financial contagion in EMBI
- **Automatic up-front full access to liquidity insurance** (substitute for international reserves)
- **Wide Basic Tier** (e.g. good standing in Article IV); **Top Tier** (e.g. solid macro) gets more access because has lower risk of solvency concerns
- **Monitoring** to seamlessly switch to an Adjustment Facility if liquidity does not do it

Example B: A family of FCLs to deal with Liquidity cum Adjustment

- **No trigger: Available on demand** (at steep rate)
- **Calibrate automatic up-front access and ex-post conditionality program** according to tiers:
- **Senior FCL** (e.g. excellent macro, such as in FCL): full access, no conditionality
- **Junior FCL** (including disqualified Senior FCL) get some automatic access and then transition to adjustment with ex-post conditionality; PCL?
- **Monitoring** to transition to Debt Restructuring Facility if needed

Example C: A Debt Restructuring Facility associated with the ILLR function

- **If and when debt restructuring is needed to regain solvency** (there is debt overhang)
- **Activation: Country call, ILLR invite (countries with good Art. IV standing)**
- **Debt workout plan including:**
 - Certification (or not) of “excusable” default
 - Arrangements for ILLR interim financing
 - Adjustment and reform conditionality
 - Guidelines for appropriate debt restructuring
- **READY FOR BOLD REFORMS?**



Example D: ILLR as a prudential tool

- Moral hazard is controlled by providing ample liquidity provision only in prima facie solvent cases
- Prior country selection to ILLR benefits incentivize countries' effort to reach eligibility standards
- Precautionary incentives magnified by:
 - No commitment fee to maximize benefit and use
 - Proactive country prequalification (all in play)
 - Tiered structure provides marginal incentive to elicit countries' effort at all levels

Constructive roles of regional institutions

- Intermediate global liquidity support:
 - Lessens country stigma (regional prequalification?)
 - Builds trust and helps political economy approval
 - Helps monitoring of effectiveness
- Supplement global liquidity support
- Ensure development effectiveness of adjustment programs and policy reform
- Do not be the weak link: Consistency of global and regional criteria reinforces FSN system



Inter-American Development Bank / www.iadb.org

KEY REFORM: Sovereign Debt Restructuring with Bankruptcy Court (instead of carrots and sticks)

- **ILLR can enforce** adjustment/debt restructuring plan with lenders (contractually-based or by accord)
- **Standstill on payments and stay on litigation**
 - Avoids system based on contract breaching and litigation, costly to countries' reputations
 - Gives ILLR time to device “optimal” reorganization plan and teeth to enforce it with standstill in hand.
- **Senior priority to interim financing**, allowing for private sector involvement (akin to country insurance) and less ILLR resources.