



Towards an international lender of *first resort*

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*"Mitigating Risks in the International Financial
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Road map

- Debt dynamics
- Confidence crises
- An international lender of *first* resort (ILFR) to forestall confidence crises
- Application to the euro zone

**See D. Cohen and R. Portes, 2004, "Towards a lender of *first* resort", CEPR Discussion Paper 4615 (also Cohen and Portes 2003)
Also D. Cohen, 'Leçons de la crise grecque', September 2010**



Simple debt dynamics

Increase of the Debt-to-GDP ratio =

real interest rate * Debt-to-GDP ratio
(*'confidence'*)

-Growth rate of the economy * Debt-to-GDP ratio
(*'fundamentals'*)

-Primary Surplus/GDP
(*'economic policy'*)



Confidence crises

- Policy affects fundamentals, and both affect confidence – but confidence is often itself fundamental!
- *Confidence crises can be self-fulfilling* :
perceived adverse shock → spreads up → deficit up → spreads up further...
- CDS market exacerbates downward spiral, in some cases interacting with credit ratings
- Thus there are multiple equilibria – how can we get coordination on the ‘good equilibrium’?



The ILFR

- Multiple equilibria → *'market discipline' can be destabilising*
- Proposal: an *'indebtedness regime'* based on market spreads
- *Mutual precommitment* – country and IMF – to act if market spreads reach prespecified level
- IMF as ILFR – policy intervention *before* crisis



The indebtedness regime

- Country commits not to borrow if spread $>$ threshold ('trigger rate' = 300 bp, say)
- This avoids 'gamble for resurrection'
- Country agrees programme with IMF, which lends at trigger rate subject to conditionality
- Country acts and Fund responds regardless of fundamentals, although they come into play in designing Fund programme



Advantages of ILFR

- Credible indebtedness regime would *coordinate expectations* on 'good equilibrium'
- Country is committed to *prudent strategy*
- IMF adjustment programme less drastic and disruptive if applied *before* crisis
- Not automatic – Fund support conditional on programme
- Implementing programme should restore market access at spreads < trigger rate – *catalytic role* for IMF lending



Potential problems

- Distortion of debt prices from ceiling imposed on interest rates
- Lending necessary to re-establish confidence might be very large – but mechanism would operate *before* debt reached unsustainable levels
- Still, an exogenous shock could hit many emerging market countries simultaneously



Within the euro zone

- When a country gives up its own currency, it loses a captive base of investors
 - no distinction between 'domestic' and 'foreign' debt
 - much of €-zone public debt held by non-residents
- Effects of ratings downgrades and upgrades asymmetrical
- Hence highly vulnerable to confidence crisis
- ILFR: any country whose spread exceeds (say) 300bp can (must?) go to Commission for endorsement of its adjustment programme
- This enables access to EFSF and anchors spreads



Summing up

- We address an important subset of crises: those arising from loss of confidence
- Such crises can be self-fulfilling
- The ILFR is a 'market-friendly' way of avoiding or dealing with a 'bad equilibrium'
- But markets can't themselves invent and implement these institutional changes
- In the euro zone, the authorities now have both a particular justification and a particular opportunity to create an appropriate institutional framework