SHADOW FINANCIAL REGULATORY COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
TEL (312) 915-7075
FAX (312) 915-8508

Statement No. 145

For information contact:

Robert Litan
202-797-6120

Richard Herring
215-898-5613

Statement of the Shadow Financial Regulatory Committee

on

International Monetary Fund Assistance and International Crises

May 4, 1998

Although the merits of additional funding for the International Monetary Fund (IMF) continue to be debated vigorously, all parties to the discussion agree on the importance of finding ways to reduce the likelihood of a recurrence of the kinds of financial difficulties that have been experienced by a number of Asian countries since the summer of 1997.

The Committee believes that three broad measures should be pursued to accomplish this objective. At the same time, because the members of the Committee have different views on whether and to what extent the resources of the IMF should be augmented, the Committee takes no position on this particular issue.

Loss Sharing By All Creditors

First, a key objective must be to insure that all actors -- governments, private equity investors, and creditors -- bear the consequences of their decisions. IMF assistance reduces adverse consequences for many classes of foreign creditors of banks that they might otherwise be forced to bear. This statement focuses on foreign lenders to local banks because recent experience suggests that they have been protected from most of the adverse consequences of their lending decisions. This "moral hazard" has arisen because countries can use the IMF assistance to subsidize the foreign currency exposures of their banks or to help fund guarantees of creditors (to dissuade them from pulling their funds out of local institutions).[1] Knowing this to be the case, creditors therefore have incentives to lend too much at inappropriately low rates to borrowers who likewise have incentives to borrow too heavily. When the loans so made are denominated in foreign currencies, countries that have pegged their currencies can experience a sudden "run" on their foreign exchange reserves if investors lose confidence that borrowers will be able to repay those loans. This is precisely what happened in the recent Asian financial crisis and what led to the requests by these countries for hard currency aid from the IMF.

If, therefore, the IMF continues to be a resource for countries in financial difficulty, it becomes imperative for policy makers to find ways to mitigate the moral hazard infecting credit decisions from the availability of IMF assistance. Otherwise, the prospect of IMF assistance will increase the frequency and size of international financial crises in the future.

In principle, one possible mechanism for blunting such incentives would be for countries receiving IMF assistance to enact legislation that would impose a minimum automatic reduction of the principal of foreign currency loans[2] extended to banks in their countries. The reduction in principal should be based upon the duration-adjusted country risk premium on the country's foreign-currency-denominated bonds. To discourage creditors from withdrawing their funds during the period when the country continues to be obligated to the IMF, the "haircuts" would be imposed only if (and when) the creditors withdraw (or fail to roll over) their claims before the IMF loans are paid back. Creditors would not be permitted to charge interest on extended loans at a rate higher than previously applied. The Committee strongly believes that the IMF should discourage countries receiving its assistance from guaranteeing any portion of its banks' liabilities, but if such guarantees are extended to foreign-currency-denominated loans, they must be limited to the amount of the principal of those loans minus any mandatory haircut. Countries that do not enact the kind of creditor loss sharing arrangement just described either could be made ineligible for IMF assistance or be required to pay a substantially higher penalty rate for such aid if it is otherwise forthcoming. Moreover, the IMF should make the enactment of such legislation one of the conditions for all countries that receive assistance.

If such a mandatory loss sharing system were in place, international foreign currency lenders to banks henceforth would include some risk premium in the interest rates they charge those banks. The amount of that premium would depend on the same factors that determine the country risk premium on foreign-currency denominated sovereign debt as well as the characteristics of the individual bank borrower. The existence of such a risk premium would

---

[1] In fact, this is exactly what occurred for bank creditors of Korean banks, who received Korean government guarantees on their loans. While the creditors also accepted lower interest loans on those loans, there is little question that they ended up better off than if the IMF had not provided assistance to Korea.

[2] This should include interbank deposits, but exclude balances used explicitly for clearing and settlement of international payments.

discourage borrowers from assuming excessive foreign currency obligations. In addition, it would strengthen pressures on the borrowing country's government to improve the quality and timeliness of disclosures of information relevant to the assessment of country risk.

There may be practical difficulties in implementing a mandatory loss sharing system for foreign currency creditors of banks. For example, it may not be possible to prevent governments from compensating creditors forced to suffer haircuts (such as providing them opportunities for new business on favorable terms). Furthermore, it is conceivable that sophisticated lenders will find other ways to develop new instruments so as to escape the pain of any formal loss sharing. Notwithstanding these and other potential practical difficulties, the Committee recommends that policy makers here and abroad explore whether some kind of mandatory loss sharing system is feasible and, if so, how it could be implemented. At the same time, by indicating its support of this particular concept, the Committee does not imply that IMF resources should be augmented.

More Transparency

Second, because markets can function effectively only if actors are reasonably well informed about the risks and rewards of taking various actions, the Committee agrees with those who have urged the need for greater and more timely disclosure of financial and economic data by governments and the private sector in all countries. In particular, governments must disclose on a timely basis their foreign currency reserves and off-balance-sheet commitments. Moreover, there is a clear need for the private sector in many countries to adopt more consistent and verifiable accounting practices (including the publication of fully consolidated financial statements) so that creditors and investors have sufficient information to make an informed decision whether to lend to or invest in private enterprises. The IMF and the World Bank should encourage countries to adopt these measures, while providing technical assistance to help implement them.

Open Banking Systems

Third, the banking problems that have played a key role in the recent Asian financial crisis have been attributable, in significant part, to insufficient international diversification of financial institutions in these countries. Countries should therefore be encouraged to open their banking markets to well-capitalized banks from around the world whose loan portfolios are likely to be highly diversified. Increasing the share of local banking assets that is owned and managed by foreign institutions would help insulate local financial systems from being destabilized when economies run into trouble, while facilitating the transfer of valuable management experience and cutting-edge financial technologies that can help lower the cost of capital to local firms.

It is the Committee's policy that members abstain from voting on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard C. Aspinwall abstained from voting on this statement.