SOVEREIGN RISK MANAGEMENT IN AN INTEGRATED WORLD

Timothy Geithner
Undersecretary for International Affairs
The Department of the Treasury, U.S.A.

Introduction

It says something about our times that the arcane and technical issues of risk management are at the frontier of initiatives to reform the architecture of the international financial system.

This conference takes place in the aftermath of a rather wrenching series of shocks to national economies and to the international financial system as a whole. These events have provoked a useful debate as to whether the source of the problem is fundamentally global – weaknesses in the system as a whole, or fundamentally local – weakness in the policies adopted by individual countries; and whether the solutions to these problems lie primarily at the global or the local level.

I think most observers would now agree that the combination of national vulnerabilities and certain features of the integrated capital markets of today proved -- to use Bob Rubin's phrase -- a combustible combination. The capital markets were willing to finance countries with conspicuous vulnerabilities on a rather extraordinary scale long past the point of no return. Risk management practices – both in terms of the policies of emerging markets and the practices of the financial institutions that financed them – were way behind the curve. When things fell apart, the resulting crisis was more acute because of the scale of imbalances that had built up, the complicated nature of the vulnerabilities masked by that build up, and the speed, force and collateral damage with which capital in today's markets can move.

My own sense is that the weaknesses in the system had important causes at the national level, and that those contributing factors that were external to the countries in crisis can only be defended against by wiser more judicious policies at the national level. Policy makers in emerging market economies should not plan to finance themselves on the expectation that those of us in the G-7 or in the IFIs will be able to produce of world of fewer external shocks or will be willing or able to provide a viable cushion against such shocks.

I want to focus my remarks on three issues:

- First, policies that are important to the sound management of the national balance sheet to limit the risk that adverse shocks to confidence will trigger a deeper fall in output.
- Second, ways to think about delivering more prudent and innovative

management of the sovereign's own balance sheet.

- And third, steps the IFIs and the rest of us can take to help make best practices in these areas more systematically adopted in emerging markets.

Our basic point – not particularly novel – is that policy makers in emerging market economies need to plan for the worst, to build in a much greater cushion against adverse shocks, to build the structures of economic policy and the debt profile to withstand seismic events high on the Richter scale – more shorter, more flexible and more resilient structures of financial leverage that are less vulnerable to risk.

I have to caution you at the beginning that I do not bring to this subject the practical experience of someone with a risk management or debt management background, only a pragmatic, common sense view of what we at the U.S. Treasury believe is a useful set of norms for the system. Our views in this area owe a lot to the work of Pablo Guidotti, Michael Pettis, and Lew Alexander. Brad Setser and Caroline Atkinson are responsible for the work we have done at the Treasury on these issues.

Risk Management and the National Balance Sheet

In each of the major Asian crisis countries – Thailand, Indonesia and Korea – weaknesses in the sovereign's own balance sheet were not the central source of vulnerability. Rather, vulnerability stemmed from the un-hedged short-term foreign currency liabilities of banks, finance companies and individual firms, in various combinations. When the exchange rate first dropped off the cliff, there was a generalized, reinforcing rush for the exit as firms rushed for cover.

In each of these cases, weaknesses in the aggregate balance sheet of a country's private sector augmented pressure on the balance sheets of the sovereign prior to and during the crisis. In Thailand, fears about the impact of floating on the balance sheet of firms with large foreign currency debts contributed to the government's decision to mortgage its reserves in the forward market. And in Korea, the need to stem the roll off of the foreign currency liabilities of the Korean banking system led the government of Korea to guarantee these liabilities, turning a run on Korea's banks into a run on the Republic of Korea's reserves.

These cases help illustrate how individually prudent individual borrower or lender decisions may aggregate into dangers to the country's overall balance sheet when a number of individual borrowers are all making the same bet. Paul Volcker has said that a mid - sized U.S. regional bank is about the same size as the entire banking system of Argentina. A prudent level of exposure by a large financial institution in an industrial country to a single emerging market, when aggregated with the exposure of banks in major financial centers can result in more risk than a small to mid-sized country can manage. Similarly, an individual corporate treasurer may decide that it is prudent to borrowing unhedged in foreign currency. But if all firms in the economy are making the same bet, the aggregate unhedged foreign currency exposure of the economy as a whole can contribute to the type

of destabilizing dynamics we saw in many countries, where a scramble for foreign currency makes a thin market thinner, and very one-sided.

The interesting question is how to reduce the risk that the conditions that can lead this type of dynamic to get going in the first place. The policy challenges are a bit more complicated than in the case of the sovereign's liabilities, because, as the Thai, Korean, and Indonesian examples pointed out, the risks lie in the consolidated balance sheet of the private sector. And to reduce those risks, one has to think about how to influence the behavior of a diverse mix of private actors and what mix of constraints and incentives is most likely to be effective.

Our sense is that the most promising steps lie in the following areas:

- Exchange rate policy: unsustainable exchange rate regimes, regimes that gave the illusion of a fixed rate without the full subordination of monetary policy to that objective and acted like an implicit guarantee, were at the heart of recent crises. Flexible exchange rate regimes, although not a panacea and not right for all countries in all circumstances, are less likely to encourage the huge build up of unhedged exposure in the private sector that ultimately proved so damaging in emerging Asia.

- The safety net: a broad and deep implicit safety net for the financial system and major corporates can be very damaging to the incentive structure. Post crisis emerging market finance has been full of anecdotes of the investor or lender who thought that a loan to a major Korean bank or to one of the chaebol was essentially equivalent to a loan to the Korean government. The absence of an explicit financial safety net and a functioning insolvency/bankruptcy system can simply reinforce the impression of a generalized too big to fail doctrine.

- Capital market development: it's hard to argue with the proposition that a greater investment in the development of local debt and equity markets would leave emerging economies less vulnerable to the types of risks that tend to build up in bank dominated financial systems.

- Prudential supervision of the financial sector: in addition to all the various pieces of the classic doctrine of good bank supervision, there are a few attempts to focus on liquidity management by the banking sector as a whole. Argentina – after the pain of the 1995 Tequila crisis – has pioneered interesting innovations here, including high reserve requirement on bank liabilities with a short-residual maturity and a contingent repo facility. Both seek to create a "liquidity buffer" that to help assure that the banking sector has sufficient liquid assets it needs to meet a surge in withdrawals.

- Perverse incentives in the capital account regime: policy biases that encourage reliance on short-term external financing, such as the regulatory and tax incentives given to the Bangkok interbank facility, the biases in favor of bank

borrowing and against equity and debt finance in Korea, are dangerous and relatively easy to avoid.

These policies -- by influencing the borrowing decisions of private firms and thus structure of the national balance sheet -- would go some distance to reducing the risk that seismic events would trigger a destabilizing rush to the exit in emerging market economies. They are not that dramatic or surprising, but they are likely to work.

Debt Management and the Sovereign

The borrowing decisions of the sovereign itself, however, is often the single greatest source of risk to an economy. Asia's crisis did not start as a sovereign crisis, but in Mexico five years ago, in Russia in 1998, and in Brazil the sovereigns own borrowing has been central.

Here's a short list of sensible things that might make up a set of best practices for sovereign debt managers.

<u>Less is almost always more</u>. The capacity to borrow responsibly is essential, but it is irresponsible to take on a level of debt that itself creates vulnerabilities, or makes it impossible for the sovereign to help absorb shocks that emanate from elsewhere. No amount of sophisticated financial engineering and parsing of specific risks can overcome a hole created by too much borrowing. Fundamentally, countries need to take no more debt than they can afford.

<u>The most sophisticated debt managers are not those who achieve the lowest possible cost of borrowing</u>. The goal needs to be to minimize exposure to risks as well as to minimize costs. It is worth paying more to create debt structures that cushion, rather than amplify, the impact of negative shocks. This means subjecting your debt structure to severe "stress tests" and finding and using debt structures that create greater resilience.

The protection of longer term debt and higher levels of reserves are well worth paying for. <u>Some of the best ways of reducing risk are also the most simple</u>.

<u>Domestic currency financing only appears expensive</u>. There is sometimes the illusion that if domestic currency debt carries a higher interest rate than foreign currency debt that it is more expensive than foreign currency debt. But a sharp devaluation can make debts fixed in a fixed foreign currency much more onerous. For many emerging markets, building the capacity to borrow in local currency means developing local markets: regular auction schedules, transparent release of economic and financial data, pushing out the yield curve by issuing at longer terms and most important of all, domestic monetary and fiscal policies that inspire confidence.

<u>Big bullets are bad for small economies</u>. Doing a large, liquid foreign currency issue, and structuring an issue around a simple and easy to price bullet payment can be

attractive since it can reduce borrowing costs. But it also creates refinancing risk that many countries would be well advised to avoid.

Make intelligent use of modern markets. The great advantage of recent financial innovations is not that they can shave a few basis points off the cost of funds. Rather, it is that innovation can help protect against a range of different kinds of risk. Some innovations that banks pitch in good times would hurt if times turned bad, others would help. Two ideas strike me as particular promising.

- Calls rather than puts. Puts cut borrowing costs, calls increase costs. But calls give borrowers an option, while puts give creditors options that they may well exercise at a debtor's moment of greatest vulnerability. Low rated sovereigns could combine the protection against refinancing risk inherent in longer terms with the opportunity to lower borrowing cost if your cost of credit falls by following the example of many U.S. corporate borrowers and issuing callable long-term debt.

- Structured bonds that share known risks with creditors. For example, a bond with a coupon that steps up when oil rises above a certain price, and steps down when oil falls below another price, could help an oil producer. Such structures are far better than pro-cyclical forms of debt, such as bonds that step up automatically when the EMBI spread widens.

Manage your off balance sheet as well as your on balance sheet exposure. Emerging and advanced economies alike have seen how bad banks and/or poorly designed bank safety nets can lead to large costs to the public sector and an unexpected weakening of the government's own balance sheet. Other sovereign guarantees of private borrowing can have a similar impact. That is why sovereign debt itself should be managed with a firm eye on the sovereign's contingent liabilities.

Pre-financing commodity price shocks. Many countries are exposed shocks that do not originate in the capital markets. A commodity price shock can lower government revenue precisely at the time when a downturn in the broader economy puts additional pressure on government expenditures. This is not the type of correlation one wants. One idea is to set aside money when commodity prices are above their historical average to help finance spending when prices are below historical averages.

Details sometimes matter. An example is the legal documentation used in international borrowing. The same principle as before applies. Debt managers need to prepare for the worst even as they hope for the best. If the market is telling you that there is a risk that you may need to restructure your debt, you should take action to reduce that risk. But also use legal provisions that would make a restructuring less disruptive for you and your creditors, and that would protect you against frivolous legal action that can make it harder for you to get back on your feet. Sovereigns should worry about the "documentation" risk created by poorly designed cross-default provision, low legal hurdles to acceleration, and the absence of majority amendment provisions.

Emerging market debt managers need to be better than their counterparts in industrial countries. Industrial countries have a longer tradition of borrowing and more developed markets: they can borrow using forms of debts that carry less risk at lower costs. Emerging markets will have to pay more than a industrial economy to have a debt structure with the same level of embedded risk. In general, the mistake emerging markets have been making is one of "under insurance" – i.e. paying too little for too little safety.

Moving Toward a More Resilient System

The challenge that the international community as a whole faces is how best to induce a shift to forms of finance that create less vulnerability and lower risk. This is hard because we live in a world of sovereign states with limited capacity, limited ex ante leverage, to induce those changes in policy that are likely to reduce the risk that we will be faced to bear the costs of future financial crises.

This challenge is particularly acute because the starting point is less than ideal. Many countries have a large refinancing need, debt with a short average duration, and a debt stock that is already indexed to inflation or foreign currencies. Conditions in the capital market are now more adverse – spreads are high, and access is limited even for stronger credits. In such an environment there is pressure to do almost anything that could cut costs. Paying more for less vulnerability is never an easy choice, but it is a particularly difficult now.

What steps might help strengthen incentives for sound financing decisions, by debtors and creditors alike?

- Make an integrated assessment of national balance sheet risks a central focus of the international financial institutions, put more attention on surveillance of sovereign debt management, and actively encourage governments in emerging market economies to pay for the insurance of a more prudent cushion of liquidity. In this context, the simple rules proposed by Guidotti and Greenspan have some merit.

- Encourage the needed investment in the provision of the high quality information on debt structures. Such information is a necessary but perhaps not sufficient condition for effective market discipline -- discipline that would tend to curb the accumulation of risk taking before, rather than after, it becomes a problem.

- Encourage more focus on better measures of vulnerability – reserves relative to short-term external debt rather than to imports, the duration of and changes in duration of the sovereign's debt structure, the amount of debt indexed to foreign currencies, contingent claims on reserves, etc.

- Make sure that regulatory incentives in the G-10 that are in place do not push

creditors to extend riskier forms of finance, and encourage creditors to price risk appropriately.

- Modify the pricing of large scale assistance by the international financial institutions so that they are not viewed as attractive alternatives for countries that actually have access to private sources of finance.

- Limit access to the IMF's contingent credit line to countries that have distinguished themselves with relatively prudent debt management policies.

- And in certain limited cases, use the MDBs balance sheets to support risk sharing instruments that can help facilitate access to appropriately structured financing. However, the capacity of the development banks to take more risk onto their balance sheets is limited; and for a host of public policy reasons. Systematic transfer of certain risks onto the balance sheets of the MDBs is not a feasible long-term solution.

There are also steps that we do not think make sense:

- Some believe that there is a compelling argument for providing a capacity to provide international sanction for a comprehensive short-term standstill on all payments, public and private. We suspect that the availability of recourse to such a mechanism with official sanction would have the perverse effect of accelerating the rush to the exits in times of stress, creating more, not less volatility.

- Others support the more systematically use capital controls to limit the capacity of private firms to finance themselves externally and roll back current levels of integration. This holds the false promise of a low cost way to reduce vulnerability, but the overall cost, in our judgement, is probably too high. Countries that have not yet chosen to integrate themselves into the global system should be careful when they relax existing controls. But a broad reversal would be a mistake. The risk of a global market should be managed, not avoided.

While there are steps that we can take at the level of the system to strengthen incentives for sound national policies to try to induce a global shift to lower levels of risk, of far greater importance is what is done at level of individual countries. The strength of the international financial system as a whole has a lot to do with the resilience of its constituent parts. That is why the issues you are debating today and over the next few days are so important.

Thank you