Proposal to Reduce Risk in Global Finance

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The financial history of the United States is marked by many large scale banking crises and large numbers of bank failures. An important reason for the large number of failures was the emphasis in law and practice on banks as local lenders. When local or regional crops (or industries) failed, local banks failed. Portfolios were insufficiently diversified to reduce risk optimally.

With expansion of international lending sub-optimal diversification has become one of the major problems of international finance. As world trade expands, countries specialize in the production and sale of particular goods and services. Local banks and financial institutions lend to local firms, financing part of their loans by borrowing abroad in foreign currency. Exchange risk is borne by local banks and financial institutions.

The growth of international lending has been accompanied by recurring financial problems. Ninety instances of banking collapse have occurred in the past fifteen years. Bailout costs in twenty of these episodes exceed 10% of the country's GDP.[1] Many of these episodes are the result of flaws in the international financial system.

Korea is one of the largest of the Asian countries that experienced severe financial problems when international lenders withdrew in 1997. Although Korean banks engaged in risky foreign ventures of their own, the loans made by its banking system were heavily concentrated in (1) a relatively small number of

[1] Charles Calomiris "The IMF's Imprudent Role as Lender of Last Resort", Cato Journal, (forthcoming, 1998).

Korean companies and (2) a small number of industries. Much the same is true of other countries in Asia and elsewhere. When these firms defaulted, the banks faced insolvency.

Moral hazard is a second problem of the international financial system. Moral hazard arises in two ways. First, the social risk borne by the countries or their citizens is large relative to the private risk borne by bankers. The IMF increases this type of moral hazard by lending (and organizing loan packages) to pay international banks at, or near, face value. International banks collect risk premia without bearing equivalent risk, then collect additional payments for restructuring their loans.

Frequently, the argument is made that moral hazard is not a problem because no government chooses to subject its economy and its people to the losses experienced in Latin America in the 1980s, Mexico in 1995, or in Asia in 1997-98. I believe this is true but irrelevant. The problem does not arise in that way.

A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. Mexico, Korea and others have faced precisely this choice. The government may choose to guarantee the loans by issuing dollar denominated securities, such as the Mexican tesobonos, or by promising to accept responsibility for private debts denominated in dollars, as in Korea. When the government offers the guarantee, it may believe the default risk is manageable or bearable, just as the U.S. government chose to believe that the risk in the saving and loan system was manageable. It is not necessary for the government to plan a debacle; the debacle is one possibility. The probability of default may be small at the time the crucial decision is taken. A finance minister faced with this choice will often prefer to avoid the crisis now, at the risk of a future larger crisis, than to accept the crisis now when many critics are ready to claim that the crisis could be avoided by giving the guarantee.

The opportunity to take a (possibly small) risk of a later crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the incentive for a finance minister to make a choice of this kind. This requires policies that change incentives by increasing the role of market forces.

One part of the solution is to have a standby lender of last resort to prevent liquidity problems while avoiding (1) bailouts of insolvent banks and (2) moral hazard. The proper role of a lender of last resort is to assure that solvent financial institutions do not fail because of lack of liquidity, not to prevent failures of insolvent banks. Domestic central banks have the power to stem a domestic, liquidity crisis. The remaining problem is the need for foreign exchange, at solvent banks, to repay foreign currency loans when international banks withdraw.

Unlike the IMF, a true lender of last resort does not rush in to protect all banks and international lenders. It charges a penalty rate---a rate above the market rate on the relevant collateral---and requires good collateral. It offers to lend at a penalty rate to anyone offering proper collateral.

These requirements are not arbitrary. They are essential. The penalty rate means that the lender of last resort will usually do no business. Borrowers will only come when they cannot get accommodation in the market place at market rates. Similarly, the requirement to offer good collateral creates incentives for banks and financial institutions to hold such assets. This reduces risk and encourages safety and solvency. Banks that take large risks and do not hold the requisite collateral would be allowed to fail if they are insolvent. Unlike the IMF, a true lender of last resort does not create moral hazard. I believe the IMF could be closed; the BIS could serve this function.

My second proposal eliminates a main source of the problem. If banks were truly international in scope, they would operate in many countries. Local lending in local currency would be part of their mixed global portfolio. Banks would diversify currency risk within a global portfolio, lowering overall lending risk.

This reform is not an untested textbook solution. British banks followed this strategy in the nineteenth century. Citicorp, in particular, has followed this strategy recently, where it was permitted to do so. In many countries, regulations protect domestic banks from foreign competition. This prevents international banks from following the sensible strategy of lending in local currency and relating risk to return within a diversified loan portfolio.

The financial services agreement, accepted by members of the World Trade Organization last year, is an important first step to gradually eliminate barriers to competition and diversification in banking and finance. In the proposed system, global banks would internalize the risk, or hedge the risk at their option.

Together, the two proposals would (1) substantially reduce risk in the international financial system, (2) separate solvency and liquidity problems, (3) greatly increase banks' incentives to hold reserves of tradeable assets that can be sold in a liquidity crisis, and (4) reduce moral hazard.