BEYOND IMF BAILOUTS: DEFAULT WITHOUT DISRUPTION

by
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International policy makers are often confronted with an unpleasant choice: either bail out a threatened developing country and its lenders or risk a crisis that could spread throughout the global economy. The probability of catastrophe may be small but the penalty is severe. Intervention has always been the decision even when it was clear that the solution would be short-lived, that emergency funds would benefit speculators, and that promises of reform were unlikely to be kept.

A third and better option exists for the international lender of last resort. On the continuum between total bailout and abandoning the market to chaos, there is an effective new mechanism that can alter the approach to disruption.

Nine bailouts in just six years have transferred one quarter trillion dollars in risk from private sector balance sheets to official ledgers. Some of the recipients are already returning to ask for more. With the exception of Russia, where $16 billion of support proved inadequate, the markets have not suffered a single dollar of loss on major emerging sovereign lending. Bailouts, viewed over time, have encouraged borrower and investor behavior that endangers the financial system.

Repeated intervention subverts the incentives that are the moving force of market behavior. Bailouts obviate the hard choices--default or reform for troubled borrowers; sound lending decisions or failure for investors--and substitute a free ride on G7 taxpayers. Capital markets have learned that there is an implicit IMF guarantee for large emerging market sovereign borrowers and that a risk premium can be collected while avoiding the risk. Countries have learned that promises can substitute for reform and that every $10 billion of IMF loans will yield $1 billion each year in interest subsidies.

Only default and the losses that follow will create the incentives to deter speculative flows in the capital markets and impose measured borrowing and serious reform on emerging governments. But there can be default without disruption.

This is a proposal for an IMF-backed facility that stands ready to buy any and all debt of a crisis government to the private sector at a support price significantly below its expected restructured value. The financial system would be insulated from contagion. The country's debt burden would be reduced to sustainable levels. Private lenders would bear losses, but losses with predictable limits. The uncertainty that leads to panic would no longer exist. The official sector would step back from its current role of guarantor of speculative capital to emerging economies and become a true lender of last resort that responds to market failure yet preserves market discipline.

I. Destructive Default: the Catalyst of Panic

A major emerging government has accumulated an unsustainable debt load. A restructuring of liabilities, including a substantial write-down, is necessary to prevent recurrence within a short time frame. Private sector investors will agree only if default is declared; no one ever voluntarily takes a loss. The official sector fears default more than either the debtor or its creditors and accedes to demands for a rescue.

Proponents of bailouts foresee unavoidable dangers to the system. If the borrower declares default, prices of its bonds will fall precipitously, far below their true value, as all buyers withdraw from the market. This will lead to forced selling and a further collapse as investors mark to market, calls for margin and liquidations come from lenders and redemptions are demanded by clients. The need for cash will first be reflected in the bonds of the crisis country and then spread to the securities of other emerging governments and finally to unrelated asset classes as investors sell whatever can be sold. Markets close.

To prevent panic while permitting the market to operate is the classic role of the lender of last resort. But past massive cash infusions to borrowers have moved beyond this mandate and encouraged larger and more frequent crises.

II. Constructive Default: an Official Floor of Support

The sole alternative to bailouts is not widespread disruption and repudiation of contracts but constructive default that provides an orderly correction for the errors of borrower and lender alike. There is a framework for default where write-downs and restructuring can proceed without systemic risk and where market discipline is reestablished.

With a strong official floor of support during the restructuring process, the financial system would be insulated from contagion and the uncertainty that leads to panic. Private lenders would bear losses, but losses with predictable limits. At completion, debt burdens would be reduced to sustainable levels.

Simultaneous announcements would be made that:

1) A debt purchase facility has been extended to the government by the official sector, led by the IMF. This AAA credit stands ready to buy any and all of the outstanding debt to the private sector at a fixed cash price that is substantially below its expected write-down value;
2) The borrower will cease payments on all debt obligations to the private sector;
3) A planned restructuring of the debt with an estimated write-down value is expected to be completed within a short time frame (3-6 months); and
4) IMF support will be provided to other emerging economies affected by the crisis.

At the moment of announcement, prices of the country's bonds would fall below the expected write-down value but they would stabilize at a level above the official support price because further decline is precluded. As the market realizes that bailouts are over and losses are possible, a rational downward adjustment in the prices of all emerging economy bonds would ensue to reflect their true risk.

The IMF floor of support should be set low enough to be unattractive to all but the most desperate investors but high enough to forestall uncertainty and panic selling. There is a trade-off. The lower the floor, the less its stabilizing effect. The closer to the debt's expected restructured value, the higher the probability that investors will sell to the IMF facility.

All debt repurchased would be pledged to the IMF as security and one-half of the proceeds of all new borrowing would be channeled to facility repayment. As the borrower repays the IMF loan, a proportionate share of the bonds held as security would be released and canceled.

Technical issues for the proposed debt purchase facility can be addressed within IMF operating rules and capital market practices. Compliance with U.S. securities law and with the terms of outstanding debt issues (including restrictions on the purchase of debt in default by the issuer and tender and voting rights during restructuring) has been ascertained.

III. Argentina: an Example

Argentina is the quintessence of what has become a recurring pattern in the international financial system--a developing nation that has accumulated a massive and unsustainable debt, fails to institute reforms to restore long-term solvency and holds the official sector hostage through an excessive 25% share of emerging market bonds.

Government debt outstanding to the private sector (net of collateral) is approximately $90 billion with a current market value of approximately 80% of face amount. Even if a credible program of reform were implemented, reduction of the debt load to a sustainable level would require a write-down to approximately 70% of face value.

Constructive default to achieve this target would be based on an IMF-led debt purchase facility with a maximum value of $54 billion to guarantee a support price of 60% of face amount. (The official sector breakdown: IMF: $34 billion; World Bank: $8 billion; Inter-American Development Bank: $8 billion; Spain: $4 billion.)

The support level of 60% of face amount would maintain the solvency of the Argentine banking system that holds significant quantities of government debt but is relatively well capitalized. Three of the four largest banks are controlled by foreign institutions (Santander, BBV, HSBC) that would provide support to their affiliates.

IV. Contained Exposure; Net Benefits to the Global System

It is highly unlikely that many investors would exercise the option to sell their bonds to the IMF facility because, as bonds are purchased, the creditworthiness of the borrower improves, the value of the restructured bonds to be exchanged rises and the position of the remaining creditors strengthens.

Theoretically, what is the official sector's exposure if all creditors accept the support offer? The private sector would absorb the entire cost of the write-down, balanced out by the high returns that emerging markets offer. The crisis country would reduce its debt burden to a sustainable level. The IMF would hold a secure claim on a now creditworthy borrower that has an obligation to dedicate half of the flow of new funds to repayment of the loan.

This is far superior to the standard bailout scenario where private investors do not bear any cost for their mistakes, the country often continues with an unsustainable burden and the IMF holds a mounting claim on a questionable borrower whose rollovers camouflage delinquent debt service. Here the intervention is final rather than piecemeal and temporary, as a series of rescue packages has proved to be.

For Argentina, in the extreme case where the entire private sector debt is repurchased under the support facility, the full $36 billion of debt write-offs would be absorbed by investors, the government's total debt would be reduced by one third and the IMF-led group would hold $90 billion in claims as security for $54 billion in loans that would be redeemed in a short time frame by the now creditworthy Argentine economy.

There are other benefits. The official sector would step back from its current role of guarantor of speculative capital to emerging economies and become a true lender of last resort that responds to market failure yet preserves market discipline. Capital would again weigh risk in the lending equation and funds would flow at attractive rates to sound developing countries. Emerging governments would learn that only prudent policies and secure financial sectors gain access to funds for growth. Fewer crises would be the result. Overall there is a net gain to the global system.