Session 5: Financial Safety Nets: How Can Regional and Multilateral Schemes Coexist?

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September 17, 2010
Tri-tier system to ensure financial stability is proposed

- National Reserves – too costly to held
- Global FSN – too slow, stigma, etc.

New development:

- Regional FSN – to make them cheaper than National Reserves while faster and less reputationally costly than Global FSN
- Yes, moral hazard problem of Regional FSN is mentioned, but mostly understated
Regional FSN: potential hazards

• **Moral hazard**
  – Risk sharing will increase a risk-taking behavior at national level
  – Regional scope of risk sharing provides new dimensions for moral hazard consideration
  – Can feed currency crises

• **Spatial hazard**
  – Regional economic linkages and region-specific shocks can emphasize risk exposure and crises contagion

• **Political hazard**
  – Non-democratic national regimes: political rent in decision making is too high
  – Democratic regimes: political reasons can also dominate economic ones
Moral hazard aspect of RFSN-risks

- Justifications for RFSN
  - decrease the costs of national reserve hoarding
  - easier provider of last resort than Global FSN

- Both contribute to increase in risk exposure at national level
  - crises might become more often (even if more easily cured)
  - misallocation of capital at national level increases

- Benefits of region-wide insurance need to be checked versus costs of real efficiency losses
Moral hazard aspect of RFSN-region

• Intensive trade flows (PTA, gravity), including within firms’ boundaries
  – Additional reason for increase in risk taking by countries with negative current accounts
    • High reserves in exporting countries
    • Importing countries in the region can take excessive risks relying on insurance provided by regional FSN
    • Exporting countries have incentive to provide insurance to secure the demand
Moral hazard aspect of RFSN-currency crisis

• Third generation model of currency crisis (McKinnon & Pill (1996), Krugman (1998), etc.)
  – Fixed exchange rate regimes in many developing countries in various regions
  – Over-borrowing by banks to fund moral hazard lending as a form of hidden government debt
  – Higher risks of currency crisis
Spatial hazard

• Business cycles comovement (Baxter and Kouparitsas (2004)) – gravity and bilateral trade matter
• Similarity of factor endowments and production patterns
  – Industry level shocks can affect countries in similar way and simultaneously
• Crisis contagion is also very region specific
• Higher probability of simultaneous crises in countries within the same region, thus making Regional FSN exscessive
Political hazard aspect of RFSN: decision making

- Non democratic regimes in many developing countries in many regions
  - large non democratic countries will tend to extract political rents in case of crises from smaller neighboring countries, which can have deteriorating effect on the political situation in the region

- Democratic countries
  - the decision to provide last resort can be driven by other reasoning than financial stability in recipient country
  - inefficiency in the long-run
Illustration: Russia and CIS

• Over 2009 Russia provided credits to
  – Armenia ($500mln)
  – Belarus ($3,5bln)
  – Kyrgyzstan ($450mln)

• Ukraine got credits from Russia only after Yanukovich became President ($2bln and some smaller one)

• Anti-crisis fund was launched by Eurasian Economic Community in 2009 with following contributions:
  – Russia: $7,5 bln
  – Kazakhstan: $1 bln
  – Belarus: $1 mln
  – Kyrgyzstan and Armenia: by $100 thous.

• There is no doubt Russia will dominate in decision making and with current government will get all political rent from those countries who will ask for help.
Controversy of Regional FSN

• National reserves serves as a self-insurance. Too costly to held. To diminish the burden
  – provide Regional Safety Net
  – fight the risks of crises
• Regional FSN can contribute to risk increase
• Is the remedy worth trying?
Can we ignore those effects?

• Suppose one needs to estimate the effect of Regional FSN on some economic outcomes (GDP, employment etc.)
• Can one treat the dummy for regional FSN as exogenous?
  – Definitely NO
• Obvious candidates for instruments:
  – trade intensity in the region (PTA..)
  – the scope for political rent (dominating regimes..)
• One will not ignore them from academic research perspective.
• Can one ignore them in policy discussion?
More important aspect of RFSN: surveillance

- Very common assumption: Regional FSN can ensure better surveillance than Global FSN
  - theoretical support: collective action theory implies that enforcement is better in small and geographically bounded groups than in large and dispersed ones.
  - what are the evidence?
    - Greece example does not fit this assumption well

- If this is true then more control functions should be delegated at regional level of FSN
  - but enforcement is crucial.
Surveillance vs. provision of last resort

• The policy instrument intended to fight some economic inefficiency should be targeted at the reason of this inefficiency as directly as possible rather than indirectly
  – to diminish the additional inefficiencies caused by intervention

• the reason for crises? Instrument
  – Lack of liquidity Provider for last resort
    or
  – Bad regulation and supervision Surveillance
Conclusions

– National reserves are better aligned with incentives to fight risks at national level, but more excessive than Regional FSN
– Regional FSN could provoke higher risk exposure of individual countries than Global FSN
– Regional FSN are (probably) better suited for surveillance than Global FSN

• Large and reformed Global FSN as a provider of last resort
• Small Regional FSN to ensure better mutual surveillance? Might be other mechanisms at regional level to improve mutual control and enforcement.
• Smaller National reserves as surveillance and regulation will improve and management of Global FSN will streamline.