CENTRAL BANKING

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WHY RESCUES ARE WRONG
Gerard Lyons

CENTRAL BANKING

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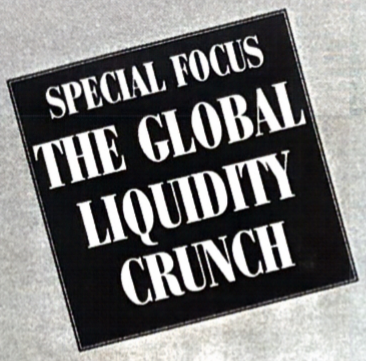

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Why rescues are wrong

Long-Term Capital Management has given perverse signals to the market. The detrimental long-term effects on moral hazard may turn out to far outweigh the short-term benefits of its rescue, says Dr Gerard Lyons, chief economist of Dai-Ichi Kangyo Bank (DKB) International, London.

There should be no surprise that Asia's economic crisis has spread around the world. At the time of last year's crisis the Asian region had already established itself as a significant part of the world economy: over one quarter of world exports came from Asia; a sizeable $823 billion of international bank lending was to Asia; in the years proceeding the crisis, Asia accounted for a huge slice of world demand for commodities; many western companies were basing their business plans on future Asian growth and, last but by no means least, private sector capital flows into Asia were huge. The corporate, economic and financial ties between the rest of the world and Asia had increased to such an extent that the shock waves from Asia have been felt globally.

There are now two key issues for world's central bankers and policy makers: the immediate need is how to prevent financial and economic contagion from spreading. The solution rests with macroeconomic policy and the need for stimulus in the major economies, including lower interest rates in the US and Europe and further policy measures in Japan.

The second issue for policy makers may not be so urgent but is equally important. This is the need to restore stability to the global financial system to ensure the problems of the last year are not repeated.

Openness and transparency are important, but a stable, thriving and successful financial system also needs a clear set of rules. This does not mean global markets need to be heavily regulated and overburdened with controls, but rules imply accountability. The behaviour of financial markets suggests investors and borrowers may not have been as accountable as they should have been. The desire to get rich quick has fed short-termism. In the last year this has been exacerbated by the dramatic shift in global economic prospects, contributing to market volatility and instability.

Dangers of the quick-fix

One potential problem that needs to be addressed by a new set of rules is moral hazard. This arises when the authorities act in such a way to reduce the losses to the private sector arising out of the private sector's behaviour. That is, the authorities distort the operations of the market mechanism and prevent the private sector suffering the full consequences of their actions. It is no use for policy makers to solve one problem if, in doing so, they create a far bigger problem whose future cost is even higher: this is what happens with moral hazard.

There have been two clear-cut examples of moral hazard during the last year: the International Monetary Fund's (IMF)

involvement in the Asian rescue; and the US Federal Reserve's part in the bail-out of the huge speculative hedge fund, Long-Term Capital Management (LTCM).

It is strange that crony capitalist countries and speculative hedge funds were being helped out at the same time that poverty-stricken countries of Africa who sought debt write-offs were not.

In Asia, IMF money was used in the support packages to Thailand, Indonesia and South Korea. In the case of LTCM, no public money was used but the Fed gave its endorsement to the use of private sector funds and engaged in the sort of behaviour that the US authorities have often criticised the Japanese for. The Fed's evident concern that LTCM should not fail means that one cannot rule out public money being used if a similar problem happens again, with the markets in a precarious state.

What sort of signal does all this send? Are some firms too big to fail? It also raises the question why western taxpayers should pay for the excesses of market participants? This is especially so when most of these taxpayers are also bank account holders and will undoubtedly pay for at least part of the cost of the bad lending decisions of international banks.

'Heads I win, tails I win' sounds fair to me

In both cases the involvement of the IMF and the Fed reduced the costs to be borne by the private sector. This matters. The success of capitalism has always been based on winners being rewarded for their success and losers suffering. Paying for your sins is necessary. If the government acts in such a way as to reduce the full cost or the negative consequences to the private sector of the mistakes it makes, then this will distort the future risk profile of these participants. It creates the culture of a one way bet: head I win, tails you lose. It may encourage greater risk taking in the future, particularly if the participants know they may not pay the full cost of any failure.

It is the same problem seen continuously in any major financial firm where traders are rewarded on the basis of their performance in a particular year. After a good year and a large bonus, the trader is more likely to take bigger risks the following year. He knows that if successful the gains are huge but if he loses he still keeps last year's bonus. The rewards profile distorts the risk taking distribution.

Economic efficiency suffers, if those taking the decisions know the costs will not be borne by them but by the government, or someone else.

If the IMF had not played a key role in Asia then a clear message would have been sent: international borrowers and lenders are not only responsible for their own actions but also

should expect to pay the full cost of any failure. This would encourage less speculative future lending and borrowing behaviour. In the case of LTCM the message would have been even clearer, particularly as those involved in giving money to such a speculative hedge fund were wealthy investors or large institutions. Bailouts, no matter how well justified at the time, come with a heavy cost as they distort the signals sent to the markets.

How many more bailouts? The authorities at the IMF and the Fed will of course argue that they acted in the best interests of all. This is not something to be sneezed at, particularly in the case of LTCM. The Fed presumably had access to all the necessary information about LTCM's financial positions and decided that a fire-sale of assets would so destabilise the markets that some innocent bystanders would suffer. Yet the Fed's behaviour in trying to stabilise the system also sends the message that some firms are too big to fail. The point here is not to criticise the IMF or the Fed for acting, as they believed, in the best interests of the world economy and stabilising the markets. The point is to recognise this was achieved at a cost and to argue for a clear set of rules to avoid a moral hazard problem in the future.

What is the IMF for? In saying this the whole position of the IMF needs to be reassessed. The IMF played an important role in the early eighties in the Latin American debt crisis. The stabilisation programmes agreed with the key affected countries such as Argentina, Brazil and Mexico helped debt restructuring and restored confidence, and led to the IMF having a big say in economic policy making. That was not uncontroversial. John Williamson's book, *IMF Conditionality* (1982) summarises the problem then faced by the Fund; "The terms on which the IMF extends its credit have been controversial for many years. Traditional criticisms, arising mainly from left-wing elements in borrowing countries but also the US Congress, allege that the Fund is insensitive to local conditions, exceedingly onerous, oblivious to national sovereignty, ideologically biased in favour of market-orientated approaches and based on dogmatic monetarism. More recently, the US administration and a few others suggested that the Fund had gone soft, approving programmes without hope of lasting adjustment, was biased against free-market solutions, and had moved too quickly into countries that could borrow from commercial banks instead."

Many of these points are still valid in assessing the Fund's role in Asia, where its policy advice was counterproductive. To this litany of problems can be added another equally important one.

The size of capital flows to emerging markets has soared. This was a contributory factor to the problems in Asia, where the combined flows in 1995 and 1996 were almost five times the flows in the six proceeding years, 1989-1994. The size of capital flows may be temporarily dampened in the wake of the Asia crisis, but it will not be long before such flows start to rise again. If the scale of future capital flows is even larger what is to be the response? Are smaller economies to decide to introduce capital controls to protect themselves? If so that would starve them of much needed inward investment and lead to a suboptimal economic performance. Or are we to expect even bigger future bailouts?

It can be no surprise that successive bailouts of strategically important economies in recent years have not dampened speculative capital flows. The Mexican rescue in the early nineties demonstrated that if you invest in a strategically important economy your downside is more likely to be protected by a future bailout. If Mexico had not been bailed out there would surely not have been such vast capital flows into Asia and the present crisis may have been averted, or at the very least may have been less dramatic.

The knotty question of rules versus discretion

In the last two decades the credibility of central banks has been greatly enhanced by the fight against inflation. Monetary or inflation targets have helped, as the credibility of central banks was linked to achieving these targets. Similarly, it may now be time to link the credibility of central banks to how they behave in their involvement with the financial markets. Whilst maintaining stability of the financial markets will be paramount the central banks should explicitly say that no public money will be used to help institutions get out of trouble of their own making.

Such a commitment needs to be credible for the markets to believe it. Private institutions need to be accountable for their actions. And private institutions are more likely to be accountable if they know that the public authorities will also abide by a set of rules.

Rules versus discretion has been an ongoing issue in economics. Sensible policy makers will clearly argue that they need to use their discretion and act with speed when financial problems emerge. But there needs to be a clear dividing line as to how much public sector involvement there can be. Borrowers and lenders need to be conditioned into making sensible decisions, based on a fair reflection of risk.