INSURING EMERGING MARKETS

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All too often, emerging economies experience severe financial distress, which in many instances lead them to the country-equivalent of bankruptcy. Recently, the IMF and the U.S. Treasury have come up with plans to facilitate an orderly restructuring of liabilities during periods of sovereigns' distress. The IMF, taking no shortcuts, advocates a full-blown International Bankruptcy Procedure, using Chapters 9 and 11 from U.S. municipal and corporate bankruptcy laws as the benchmark. The U.S. Treasury's response is more subdued; it only wants mandatory collective action clauses (CACs) on all sovereign bonds.

Still, there is a great risk that in debating the relative merits of these, the leading proposals, we will lose sight of the big picture. The top priority for emerging markets in terms of external crises is reducing the volatility of capital flows. Will these proposals really help to reduce this volatility? I believe, for the most part, the answer is no.

First, while it is true that the anticipation of an organized debt restructuring will reduce capital flows' volatility in cases where sovereigns would have restructured their external debts anyway, there are very few such cases. Both of the proposals refer to sovereign debt issued in international financial markets. Yet except for the recent Argentinean crisis, none of the major emerging market crises of the last decade would have been helped if these mechanisms had been in place. These crises were triggered either by private sector debt or by local markets' sovereign debt.

Moreover, it is difficult to make the case that Argentina today is stuck due to the strategic behavior of individual creditors holding up the debt restructuring process. But that inefficiency is the target of these proposals. In fact, Argentina is stuck today because of its collective inability to put together a coherent and credible short- and medium-run economic plan. Debt restructuring hasn't even started!

Next, and most important from a constructive perspective, what these countries ultimately need is access to hedging and insurance instruments against volatile capital flows. It makes no sense for these economies to have to self-insure through large reserve accumulation or stabilization funds. Most individuals would be "underinsured" if they had to leave a million dollars aside for a potential car collision and the liabilities that would follow, rather than buying insurance against such event -- countries are no different. Underinsurance is what greatly amplifies these countries recessions.

With these hedging instruments, well-managed emerging economies -- like Chile, or Mexico, or even Brazil-- would then be able to remove their primary source of deep recessions. The next layer of countries would still need to make progress along conventional lines, but these economies also would benefit enormously during the worst

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crises. It is true that these crises often reflect important domestic imbalances, but they are exacerbated many times over by external financial factors, many of which have little relation to internal problems.

Bankruptcy procedures do offer some insurance, but it is minimal, it comes too late, and is subject to all sorts of signaling and incentive difficulties. Will borrowers or creditors be tempted to use it too often and for the wrong reasons? Will the private foreign lenders feel that they may be short-changed?

Indeed, why not go all the way and create transparent insurance and hedging instruments, perhaps by indexing external debt in creative ways?

It is important that the insurance and hedging instruments be contingent on factors that are (largely) not controlled by the individual country. Otherwise, incentive problems and signaling fears, such as those that have condemned the IMF's new contingent credit lines (CCLs), will dampen markets' enthusiasm. Issuing external debt in local currency is unlikely to provide the solution any time soon, in the magnitude required, precisely because it fails this requirement. But Chile, for example, could solve much of its problem if it could swap its entire public and private external debt for bonds with embedded options on the price of copper (Chile's influence on this price is not enough to hamper insurance contracts) -- that is, for debt that automatically transfers resources back to the country when the price of copper falls below critical levels. Brazil, too, would be better off if its debt were automatically reduced when the high-yield spread rose above critical levels. Of course, such insurance would be expensive, but Brazil already is paying enormous premiums for debt that, if restructured, will not endow it with a fresh start.

These markets need to be developed. There are too many free-rider problems for them to emerge without a concerted effort. Wall Street should seek the necessary investors and lower its commissions to bargain levels; the business would come from the volume and from reduced overall uncertainty. The IMF should act as a catalyst, perhaps by forcing troubled economies to make the swap – the same reasons behind the lack of prudential measures in these economies are likely to lead them to undervalue insurance and hedging -- and by subsidizing well behaved countries to take the lead. It also could help by ensuring that the new insurance is not undone by the local government and private sector. This peril can be prevented with complementary monetary and fiscal rules tightly integrated with the insurance mechanism.

These contingent instruments represent a one trillion (plus) dollar market opportunity waiting to happen. Investors would win, financial institutions would win and, most importantly, the millions of people living in such volatile but otherwise promising emerging economies would win.