National, Regional and Global Insurance Mechanisms in Crisis Prevention

Remarks by

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Outline of Today's Presentation

1. Rationale for the existence of three levels of insurance mechanisms

- International Financing Mechanisms
- National Insurance
- Regional Financial Arrangements

2. Some thoughts on the Prospects and Way Forward

What are the existing insurance mechanisms?

1. International Financing Mechanisms
   - Part of the benefit of Fund membership: Financial assistance during crises
   - CCL/CAC: Fund's crisis prevention and resolution mechanisms
2. National Self-Insurance:
   - Reserve Accumulation
   - Capital Controls
   - Preventive Policies/Financial Reforms
3. Regional Arrangements to complement multilateral financing
   - ASA / BSA: Regional self-help and regional surveillance

International Financing Mechanisms

- Fund membership can be regarded as a kind of "insurance" in that there will be financial assistance in the case of a crisis.

Official Financing Commitments—1997 Crisis (in billions of U.S. dollars)				
Country	Financial Package			
	IMF	ADB & WB	Other	Total Package
Indonesia	10.1	8.0	18.0	36.1
Korea	21.1	14.2	23.1	58.4
Thailand	4.0	2.7	10.5	17.2
Total	35.2	24.9	51.6	111.7

International Financing Mechanisms

- However, the mechanism has not been ideal because:

  - Strict conditionality
  - Amount of financing is dependent on quotas
  - Return of confidence not guaranteed

International Mechanisms: Contingent Credit Lines

- Crisis Prevention: Contingent Credit Lines (CCL) set up as an "insurance facility" against contagion.

  - Never been used:
    - Costly (time-based surcharge of 150bp after first year)
    - Many prerequisites (good track record, no balance of payments difficulties, satisfactory economic programme)

  - Stigma associated with joining CCL

International Mechanisms: Contingent Credit Lines

- New insurance facility: Lessons from the CCL

1. Conditionality (even ex ante) should be less stringent
2. Surcharges should not be high
3. Confidential commitments to allay market fears of a looming crisis

International Mechanisms: Collective Action Clauses

- Crisis Resolution: Collective Action Clauses (CAC) in Sovereign Bond Contracts.
    - Ensures cleaner debt restructuring process.
    - Does not affect bond pricing

- Complementing CACs are the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets"
    - Stress on transparency and good faith
    - But: Transparency is focused on sovereign issuers providing information—should be extended to hedge funds as well

National Self-Insurance

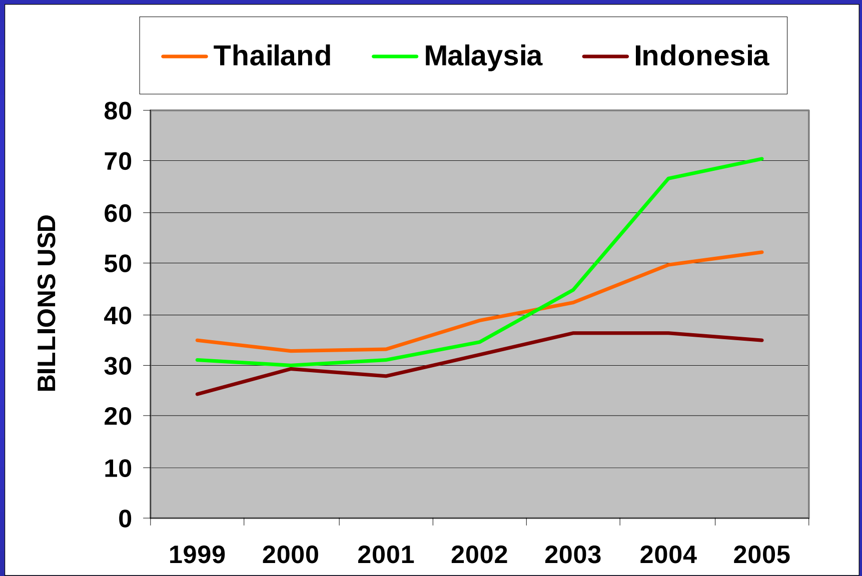
- Necessity of National Self-Insurance Schemes to complement international financing mechanisms:
    - Underprovision of the global public good of financial stability
    - Establishing credibility with international financial markets
- However: Limitation of policies for growth in the growth-versus-stability tradeoff

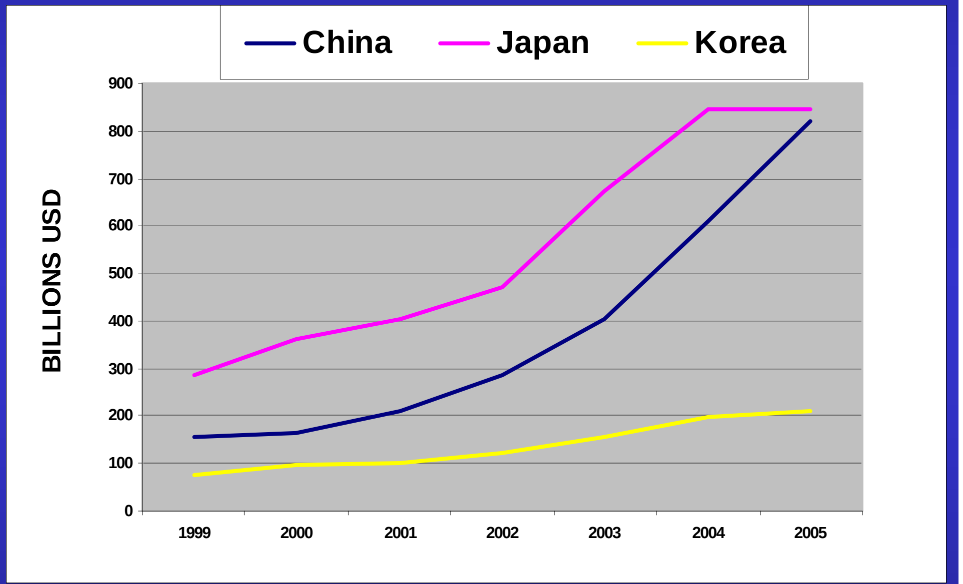
National Self-Insurance: Reserve Accumulation

- *The Measure*:
  - Reserve accumulation to cushion against future shocks
- *The Pros*:
  - Insurance against a destabilizing run on the currency
  - Offsetting volatility of private capital in/outflows
  - Confidence-building and public demonstration of official commitment towards stable exchange rates
  - Positive views of credit rating agencies
- *The Cons*:
  - Lost interest income: Reserves are usually held in safe but low-yielding bills.
  - Sterilisation costs/effectiveness
  - Affecting balance sheets
  - Does not help global imbalance adjustments

National Self-Insurance:

Reserve Accumulation: A regional comparison





National Self-Insurance: Capital Controls

- Thailand has implemented measures aiming to curb currency speculation

- Measures implemented include:

    - Nonresidents can get a maximum of 50m baht credit facilities from local FIs without underlying trade or investment.
    - Outstanding balance of Non-resident Baht Account limited to 300m baht unless waived by the BOT.

National Self-Insurance: Capital Controls

•*The Pros*:

• Ability to manage capital in-and outflows to curb volatility in domestic markets.

•*The Cons*:

• Pricy and difficulty in enforcement

National Self-Insurance: Macroprudential Framework

• Although prudential measures may be considered costly, they are a useful tool to complement monetary policy in addressing potential imbalances.

•Thailand has implemented a macroprudential framework addressing potential vulnerabilities. This includes:

(1) external stability

(2) real estate

(3) household debt

(4) credit and money supply

(5) financial markets

(6) corporate balance sheets and

(7) fiscal position

National Self-Insurance: Macroprudential Framework

- *The Pros*:
  - Protection against systemic macroeconomic risks
- *The Cons*:
  - Early warning systems might not be effective as they are based on historical data
  - Type I, Type II errors

National Self-Insurance: Strengthening the Financial System

•In strengthening the financial system, Thailand has implemented a number of measures:

- Enhancing the supervisory framework and practices
- Deepening and widening the capital market (bond market development)
- Developing a safety net (limited deposit insurance system)
- Making sure that exchange rate and asset price volatilities do not lead to banking crises

• *The Pros*:

• Protection against financial risks

•*The Cons*:

• Costly, especially to the banking sector

Need for a Bridge between National and International Insurance

• The Chiang Mai Initiative (CMI) as a working model to integrate national insurance with international financing mechanisms.

- ➢ Individual reserve accumulation but for use in the region.
- ➢ Peer surveillance and monitoring
- ➢ Large access cases still need the link with the Fund

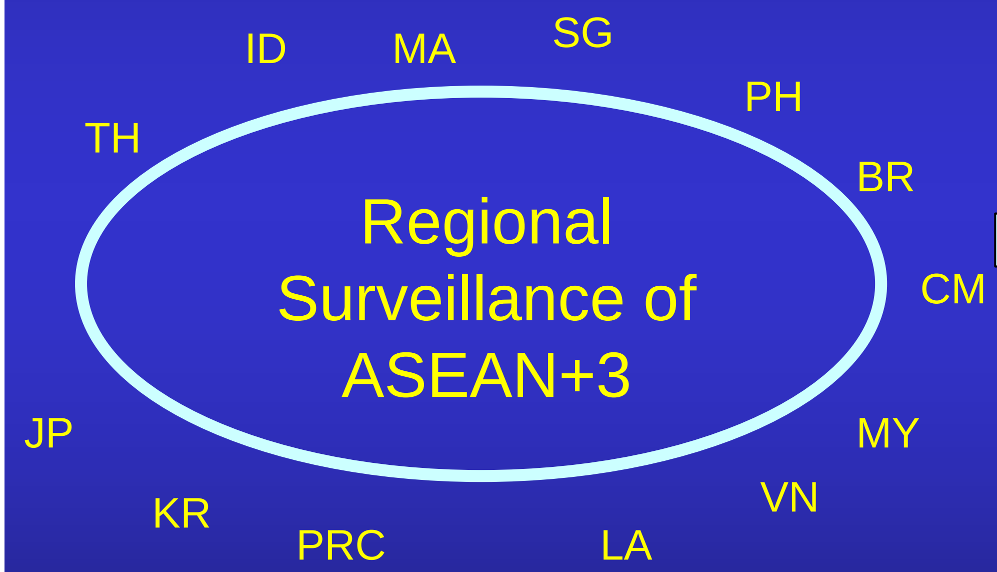
The CMI: Current Status

ASEAN Swap Arrangement (ASA)	ASEAN+3 Bilateral Swap Arrangement (BSA)
ASEAN-10 Countries $ 2 billion	Currently 5 ASEAN Countries+ China, Japan, Korea Network of $ 75 billion

- Improved drawdown mechanism:
  - Independent drawdown from the IMF increased from 10% to 20%
  - Swap activation mechanism made more efficient
  - New mechanisms for regional surveillance: Group of Experts and Technical WG on Economic and Financial Monitoring

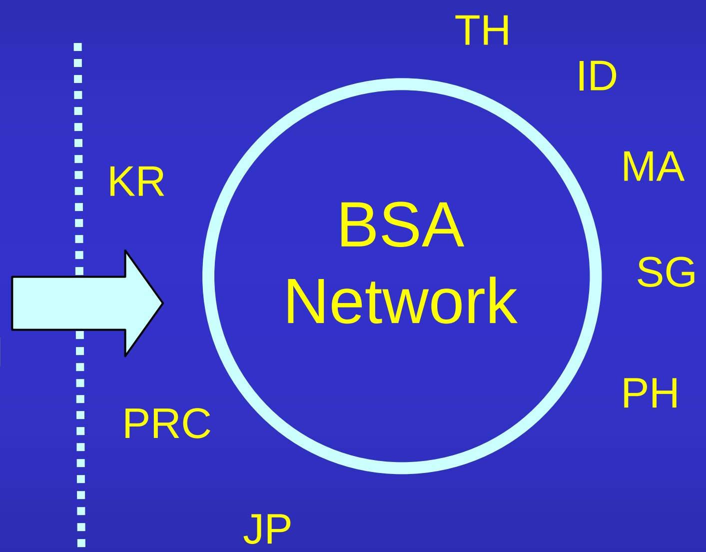
Regional Insurance Arrangements
CMI Surveillance and Lending

Surveillance



- Regional surveillance mechanisms: Economic Review and Policy Dialogues and Independent Regional Experts
- These complement the IMF's bilateral and multilateral surveillance

Lending



- First 20% as emergency funds not linked to an IMF programme: the "household medicine" before the visit to the "doctor"
- These serve as a regional-based first-line of defence and complement the IMF's financing facilities.
- Large financing: IMF linkage

Why is there a need for a three-layered mechanism?

1. Global (through the IMF)
   - Not effective enough (Funds limited by quota holdings of members)
   - Even with strict conditionality, the programme may not be credible and fail to build market confidence
2. National:
   - Establishing credibility, though crises can be contagious and heavy runs can deplete reserves
3. Regional Arrangements:
   - Complementing national and multilateral financing through peer surveillance and regional self-help

Prospects

•Regional insurance arrangements **complementing** the IMF in surveillance and lending.

• Areas of improvement for regional arrangements:

- Swifter activation
- Increasing independent drawdown
- Further building on regional capabilities

• Roles for International Financial Institutions:

- More practical policies / conditionality
- Possible revival of a CCL-type of insurance facility with easier access and more reasonable terms
- Further interface between regional surveillance mechanisms and Fund surveillance (benefit from each other's comparative advantages)