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The paper proposes a new scheme to protect private lenders including banks against default of sovereign borrowers. The central idea of the proposal is that the IMF should insure lenders by charging them a credit spread. A lender being the protection buyer would pay the premium to the IMF as a protection seller. To make money, the lender has to charge the sovereign borrower at least the risk-free rate plus the premium paid to the IMF. The novelty of the idea is that the IMF acts as a protection seller. If the IMF does not sell protection, then a private lender may obtain protection from another private agent or simply sell the loan or bond to this agent. Moreover, the paper suggests that private lenders should be members of the IMF to be able to purchase IMF insurance.

The paper is difficult to read for several reasons. First of all, it is not clear what motivates the proposal. Only at the end of the paper, at page 9, the paper says that “the only difference is that a step in the transfer of funds is eliminated. The IMF insurance then serves to internalize a positive externality: the seemingly free bailouts that private lenders do not pay for in the current system. This should lead to a more efficient level of lending and allocation of world capital.”

There exists already a credit default swap market for sovereign bonds for a couple of years. Therefore there is a private insurance system. Since privately traded credit default swaps are usually swaps with physical delivery, in default the protection seller normally gets the loan or bond against paying its nominal value. Then the protection seller takes the role of the creditor. To the extent that the IMF provides free bailouts, the creditor enjoys this benefit. Whether this positive externality is a gift to the lender, depends on its anticipation in the credit spread. If it reduces the credit spread ex ante, then mostly the sovereign benefits.

If the IMF itself sells protection through credit default swaps, then it has more discretion on collecting the money from the sovereign and imposing political constraints on him. This raises the question whether the new proposal of this paper induces any material effects. A potential effect might be that the IMF as a protection seller would make sure that the sovereign debtor does not officially default. This may lower transaction costs and also other adverse effects on the debtor economy. Also if anticipated, it would reduce the credit spread to zero and remove market discipline. But it is difficult to see that the IMF could not do the same without being a protection seller.

If the IMF crowds out private protection sellers, then this might induce lower credit spreads. Also the IMF might subsidize the credit spread and thereby lower the cost of borrowing for the sovereign debtor. But then the question is: What is the difference between this system and another system in which the IMF itself lends to sovereigns? If the IMF acts as a lender, then certainly concerns about political aspects in lending become important. There is presumably a strong danger of politically influenced lending decisions. In effect, the private market discipline which may be distorted by IMF intervention would be replaced by IMF discipline. The authors of the paper are aware of the problem and therefore suggest that private lenders should not get full insurance of the IMF. But then the costs and benefits of a mixed system need to be analyzed.

If the IMF acts as a protection seller, do we need a special insolvency regime for sovereign debtors? How do we make sure that protection selling by the IMF does not generate strong moral hazard problems on the side of the debtors? Even if the private lender retains some of the default risk, there is still a danger of excessive lending because private lenders may count on bailouts since the IMF as a protection seller has a strong interest to avoid default.

The paper also suggests that private banks should give money to the IMF enabling the IMF to lend to sovereigns. This reinforces concerns related to political lending decisions. Why then should the IMF not issue bonds itself?

The appendix of the paper presents some mathematics about the correct pricing of premia for credit default swaps. This is somewhat difficult to understand and in a sense quite naïve because it starts from binominal models. There's a huge literature on the pricing of credit default swaps. This literature is quite advanced. The difficulty in pricing credit default swaps for sovereigns is that there may not be enough data to reliably predict default events and recovery rates. This is true in particular if politics play a strong role in the default of sovereigns. A precise definition of default is necessary.

As a general comment, the nice thing with the paper is that it is quite short. But this induces many question marks. Many issues are raised which are hard to evaluate.