IMF must distinguish insolvent from illiquid
Stephen Grenville
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'Capitalism without bankruptcy is like Christianity without Hell." This is core market theology: investors must face serious penalties to make them evaluate risk carefully. If punishments are not delivered, investors will be less careful next time.

This works, more or less well, for individual companies. Enterprises are routinely wound up, with losses apportioned. Investors lose some money, but if they have diversified portfolios and if returns have reflected risk, it all works out well enough. It doesn't bring down the whole financial market.

But now the global financial crisis and the Greek tribulations remind us that this process doesn't seem to work for systemic financial problems or for sovereign debt.

Take Greece as an example of sovereign debt risk. The euro was set up to ensure each country was responsible for its own debt. There is no fundamental reason why Greece should not default or, more realistically, seek a rescheduling with its creditors. It could remain in the euro area, although this makes the adjustment much harder as it can't devalue to improve competitiveness.

Why, then, are Greece and its creditors being bailed out by other euro countries and the International Monetary Fund (which means Australia is contributing too)?

The starting point is to ask whether Greece is illiquid or insolvent. If the current situation is a result of temporary market panic, or if Greece can correct its budget position over time, the right solution may well be to treat the problem as illiquidity, providing temporary funding combined with a vigorous adjustment program. But if Greece is insolvent, any extra funding will simply delay the day when the debt has to be restructured (and may transfer the risk from the current creditors to the euro area governments and the IMF).

Solvency is never a straightforward calculation, particularly with sovereign debt. It is not just a matter of the size and currency composition of the debt, the interest bill and the growth rate. A government that is resolute enough could wind back even the most parlous debt situation. Unlike private companies that need to operate profitably to stay in business, governments have the taxing power, if only they have the political strength to use it. Greece falls into the insolvent category precisely because its government apparently lacks this capacity.

Why, then, are sovereign bankruptcies so rare? Of course the debtor country would always like to keep going with extra funding. But why are the creditors also very ready to put off the day of reckoning, by treating the problem as illiquidity rather than insolvency? Overwhelmingly, the reason is that individual creditors do well if they do not force a restructuring, but instead squawk that the sky is falling in, so others (often the IMF) bail them out.

It was not always thus. The Latin American debt problems of the 1980s were addressed with negotiated rescheduling and the issue of Brady Bonds, in effect forcing creditors to take a haircut.

But the Asian crisis shifted the norm back to bailout mode. At the heart of that crisis was the flight of volatile foreign capital. Capital had flooded into these countries without proper risk assessment. As the capital fled, exchange rates plummeted and current accounts had to be covered, which could be done only by savage falls in output. The foreign creditors were at least partially bailed out by the IMF and other bilateral support funds.

Why were the creditors not forced into rescheduling or at least given a substantial haircut? The creditors invoked "sanctity of contracts" as if they had never recognised the possibility of insolvency. The IMF, with Wall Street breathing down its neck, had no operational arrangements in place, no mandate and no desire to arrange equitable rescheduling.

Following this experience, the IMF did try to put sovereign restructuring arrangements in place, but these were unacceptable to the US, its largest shareholder. Wall Street knows that if it escalates the crisis, it can have it both ways: charge a fat premium for lending to countries that have significant sovereign risk, and yet get back full value when things go wrong.

Suppose markets had recognised the intrinsic problem and had put a higher risk premium on Greece. Greece's insolvent state would have been clearer earlier. An agreed need for restructuring would have addressed the domestic political problem at the same time: if an insolvent country can't borrow, then it must live within its means with balanced budgets, no matter how painful this is for the Greek people. Would Portugal follow? Maybe, but these two countries are still small enough for the losses to be absorbed in the portfolios of the creditors. Spain is five times bigger, but its debt position and political governance are stronger.

Every response to a crisis has its dangers. What seems clear, however, is that the current approach is illogical and unsustainable. After the bailout, creditors return and repeat the cycle, buoyed by their miraculous escape.

The main task falls to the IMF. It has been eager to get back into the lending game. After a period when it seemed to have no role, it is thrilled to be back on centre stage. But it needs to do more than hand out money to mendicants. It needs to sort out its views on illiquid versus insolvent. If there is a risk that it is lending into insolvency, it must ensure that the creditors take a significant haircut. This should be part of an overall sovereign debt restructuring arrangement. Small sovereign crises need to be isolated and contained so that they don't have the potential (aided by the market's self-serving Henny Penny alarmists) to threaten the global financial system.

Stephen Grenville is a visiting fellow at the Lowy Institute for International Policy and a former deputy governor of the Reserve Bank of Australia .