At issue: Trip wires and speed bumps in service of global financial stability: A proactive role for the IMF

Under the current IMF strategic review, a "review of the effectiveness of the Fund's instruments to facilitate crisis resolution" is planned. Ilene Grabel, Professor of International Finance at Denver University, argues that the Fund must move from being a reactive institution to being a pro-active one. The IMF should use its technical expertise to mitigate the risks that culminate in financial crises, involving a programme of 'trip wires and speed bumps'.

Since the 1990s, financial crises in developing countries have become both more frequent and more severe. The interconnected nature of financial markets means that financial crises easily spread across national borders. By now, there is incontrovertible evidence that financial crises impose significant economic, political and social costs on developing countries. Trip wires and speed bumps are straightforward, transparent policy tools that can be used to identify and mitigate financial risks as soon as they become apparent to the IMF and to national policy makers.

Trip wires are a type of diagnostic tool, indicators of vulnerability that can illuminate the specific risks to which developing economies are exposed. Among the most significant of these vulnerabilities are the risk of large-scale currency depreciations, the risk that investors and lenders may suddenly withdraw capital, and the risk that the depreciation of the local currency or an increase in the cost of new foreign loans will make it more difficult for a developing country to repay its existing obligations to international lenders.

Currency risk refers to the possibility that a country's currency may experience a sudden, significant depreciation. It can be approximated by the ratio of reserves held by the government to short-term external obligations (the sum of accumulated foreign portfolio investment and short-term hard-currency denominated foreign borrowing); and the ratio of reserves to the current account deficit (the excess of imports over exports).

Fragility risk refers to the vulnerability of an economy's borrowers to shocks that jeopardise their ability to meet current obligations. Fragility risk occurs when borrowers finance long-term obligations with short-term credit, causing what is termed maturity mismatch. This leaves borrowers vulnerable to changes in the supply of credit. A proxy for maturity mismatch could be given by the ratio of short-term debt to long-term debt.

Lender flight risk refers to the possibility that private, bi-, or multi-lateral lenders will call loans or cease making new loans in the face of perceived difficulty. An indicator of lender flight risk is the ratio of reserves to private and bi-/multi-lateral foreign-currency denominated debt (with short-term obligations receiving a greater weight in the calculation).

Portfolio investment flight risk refers to the possibility that investors in a country's stock and bond markets will sell off the assets in their portfolio, causing a reduction in asset prices and increasing the cost of raising new sources of finance. Vulnerability to the flight of portfolio investment can be measured by the ratio of total accumulated foreign portfolio investment to gross equity market capitalisation or gross domestic capital formation.

Speed bumps are narrowly targeted, gradual changes in policies and regulations that are activated whenever trip wires reveal vulnerabilities in the economy. It would be the task of policymakers within their own countries to work with the staff of the IMF to establish appropriate thresholds for each trip wire, taking into account the country's particular characteristics and its unique vulnerabilities. Critical values for trip wires and the calibration of speed bumps would be revised over time in light of experience, changes in the economy, and improvements in institutional and regulatory capacity.

Sensitive trip wires would allow policymakers to activate graduated speed bumps at the earliest sign of heightened risk, well before conditions for investor panic had materialised. When a trip wire indicates that a country is approaching trouble, policymakers could then take steps to prevent crisis by activating speed bumps. The speed bump mechanism provides a means to manage measurable risks, reducing the possibility that these risks will culminate in a crisis. Speed bumps affect investor behaviour directly (e.g., by forcing them to unwind risky positions, by providing them with incentives to adopt prudent financing strategies) and indirectly (by reducing their anxiety about the future). Together, their effects mitigate the likelihood of crisis.

Trip wires and speed bumps in practice

Currency risk can be managed through activation of speed bumps that limit the fluctuation of the domestic currency value or that restrict currency convertibility. For instance, the government can manage convertibility by requiring that those seeking access to the currency apply for a foreign exchange licence. This allows authorities to influence the pace of currency exchanges and distinguish among transactions based on the degree of currency and financial risk associated with the transaction. The government can impose or strengthen foreign exchange licensing as a type of speed bump whenever trip wires indicate the early emergence of currency risk. It is important to note that the IMF's Articles of Agreement provide for this type of selective convertibility.

Policymakers would monitor a trip wire that measures the economy's vulnerability to the cessation of foreign lending. If the trip wire approached an announced threshold, policymakers could then activate a graduated speed bump that precluded new inflows of foreign loans until circumstances improved. Alternatively, a speed bump might rely upon the tax system to discourage domestic borrowers from incurring new foreign debt obligations whenever trip wires indicated that it would be desirable to slow the pace of new foreign borrowing. In this scenario, domestic borrowers might pay a fee to the government or the central bank equal to a certain percentage of any foreign loan undertaken. This surcharge might vary based on the structure of the loan, such that loans that involve a locational or maturity mismatch incur a

higher surcharge. Surcharges might also vary based on the level of indebtedness, such that borrowers who already hold large foreign debt obligations face higher surcharges than do less indebted borrowers. This would encourage borrowers to use (untaxed) domestic sources of finance. Surcharges might also vary according to the type of activity that was being financed. For instance, borrowers might be eligible for a partial rebate when loans are used to finance export-oriented production.

If a trip wire revealed that a country was particularly vulnerable to the reversal of portfolio investment inflows, a graduated series of speed bumps would slow the entrance of new inflows until the ratio falls either because domestic capital formation or gross stock market capitalisation increased sufficiently or because foreign portfolio investment falls. A speed bump on portfolio investment would slow unsustainable financing patterns until a larger proportion of any increase in investment could be financed domestically.

Guidelines for designing speed bumps

Speed bumps that govern inflows are preferable to those that govern outflows because they exert their effects at times when the economy is attractive to foreign investors, and so are not as likely as outflow restrictions to trigger investor panic. Inflow restrictions also reduce the frequency with which outflow controls must be used, and their magnitude. Outflow controls can be useful during times of heightened vulnerability, especially if the government uses the breathing room to make changes in policy or to provide time for an investor panic to subside. Malaysia's successful use of temporary controls on outflows in 1994 and 1998 shows that temporary outflow controls can protect the economy from cross-border contagion risk in times of heightened financial risk. Graduated, modest, and transparent speed bumps can address a financial risk before it is too late for regulators to take action.

Should speed bumps be automatic (i.e., rule based) or subject to policymaker discretion? Automatic speed bumps have the advantage of transparency and certainty, attributes that may be particularly important to investors. They also have lower administrative costs. But discretionary speed bumps have advantages, too. They provide regulators with the opportunity to respond to subtle and unique changes in the international and domestic environment. However, discretionary speed bumps have higher administrative costs and require a greater level of policymaking capacity. The most prudent answer to the question of discretion is that there is no single, ideal framework for speed bumps in all developing countries. In general, the best that can be said is that speed bumps should be largely automatic and transparent in their operation, though this does not mean that regulators could or even should be expected to eliminate all discretion in the activation of speed bumps. It is the task of the IMF and national policymakers to determine the appropriate balance between automatic and discretionary speed bumps, particularly in light of their assessment of immediate technical capacities.

Responding to skeptics

Concern #1: Unpredictability and volatility of cross-border and/or cross-currency capital flows.

This approach to policy responds precisely to this concern. Rather than trying to do a better job of predicting what cannot be predicted (i.e., financial flows in unregulated global financial markets), this approach manages and 'domesticates' otherwise unruly flows.

Concern #2: The activation of trip wires and speed bumps might trigger the very instability that they are designed to prevent.

This concern does not take account of the possibility that if an economy is less financially fragile by virtue of a trip wire-speed bump programme, then investors and lenders will not be so likely to rush to the exits at the first sign of difficulty. Moreover, an economy in which financial risks are curtailed will be more resilient in the face of investor/lender flight risk.

Concern #3: Private investors and credit rating agencies do a better job of identifying financial vulnerabilities than governments.

The panicked responses of private foreign and domestic investors to identified risks can actually aggravate financial instability. Evidence shows that assessments by credit rating agencies failed to highlight emerging problems in East Asia, Argentina, or Turkey.

Concern #4: Evasion

Policy evasion cannot be ignored. However, the middle-income countries that have the most to gain by this approach are also in the best position to enforce them. A degree of evasion does not imply policy failure.

Concern #5: Lack of technical policy-making capacity

Those developing countries that have the highest levels of policy-making capacity are certainly in the best position to utilize trip wires and speed bumps. Policymakers in these same countries have the most to gain by curtailing many of the risks that they target. The technical prerequisites for operating trip wires and speed bumps are no greater than those that are demanded of policymakers that operate in an environment of liberalised, internationally integrated financial markets. Moreover, technical capacity can be acquired, particularly were the IMF's role reconceptualised to provide the needed technical support.

Concern #6: Increased capital costs and lower rates of growth.

There is no unambiguous empirical evidence of a trade-off between speed bumps and increased capital costs or reduced growth. Although foreign investors value the liquidity associated with unregulated financial markets, they may come to favour economies that give them less reason to fear financial crisis. Developing economies may find it substantially *easier* and *less costly* to attract private capital flows if they reduce their vulnerability to crisis.

The trip wire and speed bump programme represents a promising means by which the IMF can reduce the specific types of financial risks that so often culminate in costly and painful financial crises in developing countries. The chief advantages of this approach are that it can target only those risks that policymakers deem most important, it can be implemented gradually, and it is transparent. Moreover, this approach provides a way for policymakers to promote global financial stability, to manage financial integration, and to prevent interactions with the Fund that are corrosive of policy space.

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