International Lender of Last Resort: Discussion

Henry Kaufman*

I am in the fortunate position of not having known in advance what Jeffrey Sachs was going to say but having read a lot of what he has said in the past. That circumstance gives me quite a bit of freedom here to express my own biases, beyond what Sachs has already said. And I must say I admire the fervor with which he presents his views and the clarity with which he puts them forth.

I want to make a couple of comments first on this lender of last resort function. I think playing the role of lender of last resort to domestic institutions is one thing. Playing lender of last resort in a global sense is extraordinarily different and really much more complex. A central bank is usually the lender of last resort to the commercial banks and to no one else, although last September and October in the United States we came much closer to the central bank intervening in the open market process. In the United States, we have also seen occasions when the government has been the lender of last resort to nonbanks, for example, when we go back to the Chrysler and the Lockheed problems.

Second, I think we ought to recognize that in Europe the new European Central Bank has limited lender of last resort responsibilities. The residual domestic institutions involved, the domestic central banks that are left on the Continent, are supposed to play the supervisory role but they have no ability to create credit.

Third, the IMF was never really intended to be a lender of last resort. Its basic mandate did not encompass it and its resources are, of course, quite limited, considering the size of the global financial markets today. And besides, decision-making at the IMF is a cumbersome process.

*President, Henry Kaufman & Company, Inc.

From my own viewpoint, what I think is really needed is not so much a global lender when we get into problems. I think the need is to prevent problems, to have a supervisory and regulatory process in place that limits damage around the world, rather than to get into damage control. And there is much less emphasis on prevention, because everybody wants ready access to credit rather than adherence to a code of conduct.

Now a couple of comments on what Sachs has discussed. Sachs, of course, places great emphasis on short-term capital flows. And that is understandable. But I think he underestimates the changes that have happened in the global financial markets, which are now securitized, globalized, tradable, and so on. And what happens in the note markets and the bond markets and the equity markets around the world has tremendous impact on lenders and investors when a difficult situation arises. All you needed to do was pick up the paper and to listen to what was happening around the world and the quotations that were coming forth on how much stock prices were down and how much bond prices were down. That kind of movement in the securities markets can immobilize a country just as much as the inability, perhaps, to attract short-term funds.

It is true that short-term funds mean that you have to pay somebody at a specific date, within a 12-month period. But you can also gain time from the rest of the marketplace, by the developments in the open credit market. And the open credit market is increasingly important. It is no longer just the kind of market we are in right now, where the dominant role is played by the banks. The negotiating process goes beyond the commercial banks in some instances, as we saw, for example, when the Mexican problem occurred back a few years ago.

The other matter that I want to mention is the failure of the major industrial countries to take into consideration their own policies and the implications of those policies for the developing countries. After all, there was a massive creation of liquidity, by us in the United States, by Japan, by some of the Europeans. And we in the financial markets know how to arbitrage that liquidity. We push it out to wherever there is a reasonable rate of return.

Now this situation has an imperialistic aspect. All that liquidity that the industrial countries generate seeks high rates of return, but developing countries do not have the finesse, the will power, the skill, and the talent to say "Do not give me all that money." They take that money and they succumb to serious financial problems. When that occurs, industrial countries often come in and say, "We will help you out, we will buy your banks, we will buy your corporations, but the price is going to be different than it was four or five years ago."

Now that is a process that, from a political viewpoint, I believe is not that palatable. That is why the important issue, to a large extent, is what

is in place in the industrial countries and what those countries will do to behave according to a reasonable code of financial conduct. And after listening to last night's presentation, I came away with the conclusion that, because there are so many strongly vested interests that will not push quickly toward reasonable behavioral standards, we will make only incremental change in the supervision and regulation of major financial markets.

Beyond this, let me just make a couple of other comments here, from a global viewpoint. When you look at the marketplace today, we have modern securitized markets, where from time to time we find an illusion of liquidity. That, of course, is encouraged a lot through the securitization process. And, therefore, occasionally you get classical financial institutions making loans abroad with the expectation that those loans will be securitized and therefore that the process will diminish the short-term risk by passing it on to somebody else in the system. But we also have to recognize, in the world that we are in, that marketability is not liquidity, and that marking to market is now an important underpinning of our financial institutions. Years ago, life was easier. Years ago, a bank made a loan and when someone got into financial difficulty, you really did not have to mark to market. There was a hesitancy to do so; you lived in the illusion that the loan was still worth par.

Today you cannot do that any more. And marking financial assets to market is not an exact science; it is not a matter of looking at the last quote that you pick up in a newspaper, it is not a matter of using the last quote you got from a dealer, who now will perhaps say to you, "Well, that is just an indication. Ninety is an indication, but if you want to sell, we will pay 80." And what follows is financial stringency. The illusion gets exposed and the system has to confront an enormous harshness.

Another dimension to these issues is the problem of modeling risk. The marketplace now wants to quantify risk, while the central banks want to move to a qualitative approach, to a judgmental approach. It should be noted that modeling risk is based on historical patterns and on historical pricing. It cannot fully take into consideration what happens when things go out of kilter, when a crisis occurs. And you have an enormous dilemma here, which sharpens the problem that we have in managing a really global financial system.

One other thing. In this global financial market, we in the private sector cannot rely on the IMF, we cannot rely on the private rating agencies, to tell us whether a credit is improving or deteriorating. And the flow of information to allow us to make a reasonable judgment is not very good, at a time when we are in a period of substantial liquidity and driving to achieve greater and greater financial gains.

So to come back to what I said earlier, my argument has always been that the need is not for a lender of last resort, the need is for improved supervision and regulation over the major risk-takers and the major

markets, and the improvement has to begin at home. After all, emerging countries are emerging countries, and industrial countries are industrial countries. And there is always going to be a difference, a reason why one is emerging and the other one is industrial. We really have to begin with the process of improving the system within the industrial countries. After all, no matter what happens in the emerging countries, the result will never be a systemic risk. If something happens in major industrial countries, it will. And if we could improve oversight over the major global markets and institutions, the risks would be significantly reduced and the talk about a lender of last resort would diminish.