The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Memo to the Commission on Liquidity Support and Financial Market Restructurings

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1. It appears that the massive amounts of liquidity support from Central Banks have not had the desired effect of increasing lending.
2. This should not come as a surprise: adequate capitalization of banks is a necessary but not sufficient condition for lending
3. In some countries, much of the money spent on capital injections has been offset, through payments of dividends, bonuses, acquisition of healthy banks for cash, and new holes in balance sheets created by defaults.
4. That is why it is imperative that any capital injections be accompanied with measures to stem foreclosures and that directly stimulate the economy.
5. Moreover, the uncertainties associated with bank balance sheets remain large, given the large derivative positions, the uncertainties about counterparty risk, the on-going risk of defaults, and the continuing uncertainties about the business climate.
6. Many developing countries have faced similar problems of banks with adequate liquidity to lend not doing so. In some cases, this is because they view alternative "investment" opportunities—lending to governments, or lending abroad, speculating on capital gains from exchange rate changes—as more attractive than lending to domestic enterprises. In such circumstances, governments need to change the incentives facing financial institutions to induce them to lend.
7. For instance, financial institutions should not be allowed to earn a spread, beyond a minimal transactions cost, between the deposit rate and the government T-bill rate. There are a number of ways that such a policy can be implemented.
8. Providing interest on reserves held at the Central Bank, while helping recapitalize banks, reduces the incentive to lend by reducing the cost of not-lending.
9. Regulations that restrict currency mismatches between assets and liabilities reduce the scope for foreign exchange speculation. The imposition of heavy taxes on capital gains from currency appreciation affects incentives.
10. There may be other ways by which governments can provide incentives for lending, e.g. by awarding deposits of government balances to financial institutions that offer the lowest (risk adjusted) lending rates and/or that have the best lending performance using other metrics.
11. The injections of equity and the acquisition of troubled assets (or the provision of guarantees), while it may be important for restarting lending, provides large opportunities for hidden redistributions, with terms that do not adequately compensate the public for the risks assumed.

12. These problems are exacerbated when there is less than full transparency in the transactions. Many of the liquidity actions (both by Treasuries and Central Banks) fall short of accepted standards on transparency. Some Central Banks have claimed immunity from freedom of information acts. In other countries, Central Banks have chosen to limit themselves to standard forms of liquidity support, leaving to the political process (through Treasury action) to assume responsibility for lending activities, guarantees, and other actions which provide direct credit to the private sector and/or entail the public sector assuming large risks, beyond the normal levels associated with Central Bank activities.
13. In the past, bank restructurings have often been associated with large adverse wealth redistributions. Such redistributions are of particular concern given the large increases in inequalities in recent years, given the underlying problems of inadequacies of aggregate demand, and given the large increases in national debt in many countries, including those that will be associated with bail-outs and fiscal stimuli.
14. The effects can be partially mitigated by imposing heavy capital gains taxes (in excess of 50%) on the resulting gains in share prices, but implementation of such a tax poses problems.
15. Similarly, direct lending by Central Banks poses large risks on the public purse, as most central banks are not well poised for credit assessment, and poses large opportunities for hidden redistributions, with risk premia less than they should be. These problems are exacerbated by the lack of transparency in the actions of some Central Banks.
16. In providing credit and credit guarantees, governments and Central Banks should be attentive to some of the same criteria used in evaluating stimulus expenditures: (a) The induced spending should have a large multiplier; and (b) the induced spending should help address the country's and the world's long run problems. America, for instance, has been marked by excess consumption. To encourage lending in support of further consumption may be a mistake.
17. Given these problems, it may be desirable to create new lending institutions. This is especially the case under the current circumstances, where financial institutions have not shown adeptness at judging credit worthiness, and where many financial institutions have switched from the "storage" business into the moving business.
18. Given the magnitude of the support provided to American financial institutions, had new institutions been created, the potential for new lending would have been substantially larger than under the TARP program.
19. Guarantees provided to some institutions and not others may lead to large distortions in credit markets. Determining the appropriate risk adjustments may be difficult. In the absence of appropriate risk adjustments, such guarantees represent an unfair subsidy, a trade distortion which can undermine domestic financial institutions in developing countries.
20. Given the limitations of credibility of such guarantees by developing countries, even when there are appropriate insurance charges (which there have not been), the guarantees may represent a trade distortion.
21. Developing countries may have to protect themselves against the effect of these trade distortions, by restricting capital outflows, by imposing countervailing

duties on foreign banks receiving such guarantees (and other subsidies) operating within their borders, and/or by imposing lending restrictions to ensure that more of the benefits of such subsidies are received by those within the developing countries.

22. To reduce the likelihood of a financial sector trade war, it is imperative that developed countries offering guarantees and subsidies to banks operating within their countries extend direct assistance to developing countries, to enable them to offer comparable guarantees and subsidies.
23. Providing a credit facility to developing countries (directly, or through their Central Bank) help support lending by developing countries to their enterprises should, accordingly, be given high priority. Otherwise, there is a risk that existing global inequities will be exacerbated.