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Global Insurance Pool Would Reduce Financial Risks, Prasad Says

By Caroline Salas Gage - Aug 27, 2011

Countries around the world should establish an "insurance pool" to lower the risks caused by emerging-market countries' hoarding of foreign exchange reserves, according to Eswar Prasad, a senior fellow at Brookings Institution and a professor at Cornell University.

"Given the deteriorating public debt trajectories of reserve currency economic areas, the long-term risk on emerging markets' external balance sheets is shifting to the asset side," Prasad, a former head of the China division at the International Monetary Fund, said in a paper presented today to the Federal Reserve's annual symposium in Jackson Hole, Wyoming.

"These countries may be forced to rethink the notion of advanced economy sovereign assets as being 'safe' assets, although they are certainly highly liquid," Prasad said. The U.S. this month lost its top AAA credit rating from Standard & Poor's.

Under the proposal, a country would "pay a modest entry fee" of up to $10 billion, and an annual premium for "insurance that it could call upon in the event of a crisis," the paper said. The cost would depend on both the level of insurance and "the quality of a country's policies," which would "strengthen moral suasion and get a country to at least partially internalize the effects of its own policies on global risks," Prasad said.

The premiums would be used to buy a portfolio of government bonds from the U.S, Europe and Japan, with central banks from those areas "obliged to backstop the pool's lines of credit," the paper said.

Bond Holdings

Emerging market nations' accumulation of developed countries' bonds "allows advanced economies to get easy financing for their fiscal profligacy," Prasad said. The size of their stakes also caused concern during the crisis that "financial markets could be further destabilized" if they dumped their holdings of Treasuries, he said.

“Thus, in many ways, massive reserve accumulation makes those reserves less valuable at a time of global crisis and in fact reduces the value of insurance as it heightens global risks,” Prasad said.

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