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8. Swapping Your Country’s Risks

You’re a citizen of a developing country notorious for its boom and bust cycles. How do you prevent the value of your assets from disappearing during the next economic downturn if capital controls prohibit you from exporting capital overseas?

You’re the president of the same country, and you’ve pledged to reduce your country’s dependence on a single industry—silicon chips, say, or textiles. How do you diversify your economy without spending tens of billions of dollars that you don’t have and that would be better used for improving the industries in which your country already enjoys an advantage?

The answers to both questions may well be the same: the equity swap, a financial tool that works in much the same way as its famous cousin, the interest rate swap. Imagine that you are an institutional investor, such as a trust bank or a mutual fund, in a developing country and you want to reduce the risks of your domestic stock holdings. You could create an equity swap, arranging with a number of large foreign investors to exchange the dollar returns on your home-country stock investments for the dollar returns on an equivalent amount of investments in other stock markets. The magnitudes of the exchanges would be determined by the “notional,” or principal, dollar amount of the assets deemed to have been swapped.

These agreements would effectively transfer the risk of your home-country stock market to foreign investors and could provide you and other domestic investors with the risk/return pattern of a well-diversified world portfolio. Since there are no initial payments between parties, there are no initial capital flows in or out of the countries involved, which would reassure governments worried about dependency on skittish foreign investors. Subsequent payments involve only the difference between the returns on the two assets.

So let’s suppose that you enter into an equity swap agreement with a U.S. mutual fund in which you exchange the returns on \$1 billion invested in your domestic market for the returns on \$1 billion invested in a global stock portfolio. If the global stock market portfolio earns 10% over the subsequent year and the developing country market earns 12%, you pay $(.12 - .10) \times \$1$ billion, or \$20 million, to the mutual fund. If your market underperforms the global stock portfolio, the swap generates net cash flows to you (reversing the numbers in our example gives you a net inflow of \$20 million). Note that you make payments only when you can best afford to—when your local market outperforms the world markets.

Foreign investors—including U.S. mutual funds—should be willing parties to this kind of deal. Using swaps, they would avoid both the costs of trading in individual securities in the local markets and the problems of corporate control that arise when foreigners acquire large ownership positions in domestic companies. The situation is unlike that of investments in equities or debt in that foreign investors’ default or expropriation exposure would be limited to the difference in returns instead of the total gross return plus principal (that is, \$20 million versus \$1.12 billion).

The equity swap also makes a useful policy tool. Suppose the government of Taiwan wanted to reduce its economy's dependence on U.S. demand for electronic products. Following the usual practice, it would probably sink billions into creating national champions in another industry—automobiles being a typical example. But if other countries' experiences are anything to go by, that would be billions of dollars very badly spent. The diversification could be achieved much more cost-effectively through an equity swap whereby the Taiwanese government would pay returns on a world electronics portfolio in exchange for returns on a world automobile portfolio. In this way, Taiwan would eliminate its exposure to the *world* chip market, over which it has no control. At the same time, it would retain the economic gains from and its risk exposure to the *local* component of its electronics industry, which it does control and in which it can continue making capital investments. The logical counterpart would be a country whose economy is heavily dependent on the automobile industry. With this approach, countries could focus on industries in which they have a comparative advantage and still pursue efficient risk diversification.

All the conditions for an active market in equity swaps already exist. There's no need to create a special exchange for them—swaps are bilateral agreements, and positions are unwound simply by entering into another agreement. Contract terms are standardized under International Swaps and Derivatives Association agreements. In addition, there's a considerable body of global law and convention relating to swap contracts that can be carried over from the interest rate and currency markets. Using mixtures of existing traded indices as the underlying assets would ensure liquidity and make the settlement mechanics fairly straightforward. Contract credit risk is also an important consideration, but here, too, a lot is known about designing solutions, whether by a combination of mark-to-market collateral, purchase of private-sector performance guarantees, or efforts involving government and quasi-government institutional guarantees. And as we've seen, when used for diversification, the contracts call for payments by the party that is doing better economically and thus has the ability to pay.

So far, the market in equity swaps is relatively small. According to statistics from the Bank for International Settlements, as of June 2003, the outstanding notional amounts of assets covered by equity swaps and forward agreements amounted to \$601 billion. By comparison, the notional amounts covered by currency swaps totaled \$6.4 trillion, and the number for interest rate swaps was a staggering \$111 trillion. But once investors and governments start to realize the power of the equity swap, we can expect it to take a much greater share of the overall business in asset swaps.

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