Adam Posen: Good morning, ladies and gentlemen. Welcome back to the Peterson Institute for International Economics. The snow or the so called snow or the shadow snow we get in Washington, has not deterred our attendees and has certainly not deterred our speakers, though we are going to get started.

It’s my great pleasure to have everyone with us for an actually very timely and important set of discussions in the global state of debt and deleveraging. In this effort we are partnering here at the Peterson Institute with our friends from McKinsey Global Institute, under Susan Lund and colleagues and we’ll be distributing copies of their new report on debt and deleveraging later in the program.

We also have the benefit of the general counsel of the IMF, Sean Hagan, with us as part of our ongoing efforts to have the IMF come meet us and greet us and discuss things in an open manner, which they’ve been very eager to do and we’re grateful for that.

Let me, if you will allow me just one minute of setup. The term debt has become fraught in recent years in a way that is exceedingly rare to think about. Remember that as everyone invokes Shakespeare, Polonius’, neither a borrower nor a lender be, the point of Polonius’ speech is that he’s an idiot and if you read the whole speech, Shakespeare is portraying him as someone who contradicts himself seven times in the course of the soliloquy. And so the idea that we have this great pronouncement against debt is actually something that has only gotten force in recent years.
But of course right now in the aftermath of the financial crisis, it is something that even if Shakespeare was not advocating something many other people are advocating to, to rethink our whole consideration of debt, how we treat borrowers, how we deal with overhangs of debt, and has there been progress made.

And what we’re trying to do today is have a very practical dialogue between the active proposals and thinking on debt restructuring, on de-leveraging with fresh data and assessments of how bad the situation is. And we’ve chosen, not entirely arbitrarily, to split this into two issues, although they’re obviously related, dealing with sovereign debt and de-leveraging in the first case and then dealing with debt and de-leveraging in the private sector around the world in the second case.

Now, if it wasn’t for minor things like Greece and Ukraine and Argentina and Venezuela and Puerto Rico and a few others, we might have focused solely on the private debt. But actually sovereign debt and de-leveraging is not something we’re going to get away from and the IMF, to their credit, has tried to advance the debate on how to deal with that.

And so today’s first panel is to deal with sovereign restructuring, de-leveraging, a new regime perhaps, new steps that the official sector can take, the private sector reactions to it, and Adair Turner’s specialty, does this entirely miss the point?

Speaking first and so our lead off presenter will be Sean Hagan, who is, of course, General Counsel and Director of Legal Department at the IMF. He advises the management, the executive board on all legal aspects. He’s been in this job for quite some time. Prior to beginning work at the IMF, he was in private practice in New York and in Tokyo. He’s a proud graduate in international political economy from the LSC and a Juris Doctor from Georgetown, and has been out there on this issue and we’re delighted to have him with us.

Following him will be Adair Lord Turner, who has combined his careers in public policy and business and academia. I and many of you got to know him when he was Chairman of the United Kingdom Financial Services Authority during the crisis. He is now a Senior Fellow at the Institute for New Economic Thinking. He previously served at Standard Chartered Bank, Merrill Lynch Europe, Federation of British Industry, and of course grew up as a McKinsey person, and now has come full circle, in part to join again with McKinsey. And as many of you are aware, he has a book under way on debt. He thinks debt is bad.

The third person is our esteemed colleague, Anna Gelpern, who splits her time between here and Georgetown Law, where of course, she is a
Professor of Law. I’m being too facetious. Anna, we treasure the fact that she has an affiliation with us. She’s one of those unique people, Sean may be one of the few others, who’s both a lawyer and can speak to economists in a constructive, analytical way that of course, makes her great fun at parties.

Anna has written some extremely pressing and practical work over the last year on the Argentina situation, on the Ukraine situation, on notions of pernicious debt and restructuring, and is going to give her unique perspective.

And then finally on this panel, is our colleague, Ángel Ubide, who splits his time as Co-director of Global Economics for D.E. Shaw Group, a huge financial investment firm, but is also a Senior Fellow here. He’s been deeply involved in the Euro Debate. He was the co-editor with me of our recent briefing on restructuring the Euro and he is here to give us a bit of market reality check on some of the proposals in the first panel.

So thank you for bearing with me. Now, all the introductions are out of way. We can get right into the discussion. This is all on the record and after our four commentators we will open it up to comments from the floor. Sean, do you want to lead off, please?

Sean Hagan: Thank you, Adam. So as Adam has indicated, we at the Fund, have been engaged in a relatively comprehensive review of our approach to sovereign debt restructuring and I thought it would be useful to give you a sense of where our thinking is at this stage.

Much to your, no doubt, annoyance or frustration, I am not going to be able to talk about our current engagement in Ukraine or Greece, nor about the implications of some of these ideas for those countries. I would point out that if these reforms were adopted by the board, which cannot be assumed, at least with respect to the lending framework, it would take at least six to nine months before they were to come into effect. So this discussion has been going on for quite a long time and is not going to be resolved in the next couple of months.

When you talk to debt restructuring specialists, even in the corporate context or the banking context, they’ll often divide the system or the issues into three. First, what is the trigger? When do you start the process? And there’s a whole set of issues here about incentives and the ideas that you want to do it early enough so that you don’t destroy value by delay.

The second is once the process has started what is the framework for the negotiation? What is the process, both between the debtor and the
creditors and also among creditors? Because often this is complicated because it’s an inter-creditor debate.

And the final stage is the design of what I refer to as the closing mechanism. What is the framework that you have in place that makes an agreement that’s been reached by the debtor and a majority of its creditors binding on all the creditors?

And we’ve looked actually, we are looking at all three phases of this in the sovereign context. They’re different in the sovereign context but at a certain level of abstraction I think it’s a useful taxonomy for looking at the issues. And I think it’s fair to say that we’ve made the most progress on the last stage, which is the design of the closing mechanism. Which is how do you address collective action problems by basically enhancing the legal framework to bind minority creditors?

Now, that might seem odd starting from the back, but actually what’s important to realize is that having a good framework at that stage has positive feedback effects for the rest. It defines the leverage in negotiations, but most importantly removing uncertainty on collective action problems enables the process of restructuring to initiate at an earlier stage because there’s less uncertainty as to whether or not you’re going to be able to close.

So what I’d like to do is to start off by talking a little bit about the progress that we’ve made on this closing mechanism and then talk about where we’re sort of in the middle of the process, which is on the trigger and point out at the end that on process we haven’t started that discussion, although I know that a number of people in the audience are very interested in the Fund’s lending into arrears policy, which really is a critical component in the middle phase of the restructuring discussions.

So on the closing mechanism, I think the issue here is relatively straightforward in theory. We’re talking about collective action problems. It’s a form of market failure. It’s not unique to the sovereign context. Many corporate insolvency laws are designed to address these issues that enable a majority of creditors to make an agreement binding on a minority.

I think it’s fair to say that historically collective action problems have been less significant in the sovereign context, partly because of the rather sui generis legal nature of claims on the sovereign, even though over the last 30 years it’s become much easier to get a judgment against a sovereign. Many countries have modified their sovereign immunity laws to allow for that. It’s much more difficult to actually satisfy that judgment
by finding assets and that has been a source of considerable frustration for judgment creditors.

The other thing I would say is historically, as an institutional matter, creditors have essentially wanted to preserve long-term interests with their sovereigns and therefore have not resorted to sort of aggressive litigation tactics. This was the case, for example, during the 1980s.

Well, I think for both institutional and legal reasons that state of the world has evolved, partly because of disinter-mediation. Many claims now are held by bond holders who don’t necessarily have long-term interests relationships with the sovereign and are willing to, basically, maximize the value of their claims. If that means litigation that’s also an option that’s on the table.

But more importantly, I think there have been significant legal developments, which Anna has followed very closely in the case of Argentina, but this is a development that really started back in Peru, which is creditors have come up with a strategy where they don’t necessarily need to find assets. What they can do is get a court to interrupt payments to the creditors who had agreed to go into the restructuring and interrupt payments on that restructured debt. And of course, this is the celebrated feature of the Second Circuit’s decision on Argentina, the NML case with the interpretation of the pari passu clause.

And of course, from a collective action perspective it raises at least two issues. One is now you actually have a hold out strategy that’s viable, so it may increase the number of hold outs. But secondly, if you are inclined to accept the deal you may be less inclined to do so because payments to you could actually be interrupted, so it creates a degree of uncertainty.

Now, how much uncertainty? Well, one of the really interesting discussions that’s going on in the legal community is how broad of a precedent is the NML case in Argentina? If you read the case carefully it’s based on a course of conduct. And the question is what course of conduct are they talking about? Is it the lock law adopted by Argentina? Is it the persistence in the default? There’s a lot of discussion on this issue. We issued a paper recently where we tried to walk through what the different considerations are, but suffice to say that there is enough concern that many creditors, have themselves basically, engaged in a process of modifying bond documentation so as to basically reduce the risk that this disruptive litigation could create in other cases.

And there’s been a process underway for almost two years now with the International Capital Markets Association, the US Treasury, who I want to acknowledge if anybody is here who basically played a key role, and IMF
staff. We’ve had a very extensive discussion about modifying collective action clauses to address this problem. Collective action clauses are clauses in contracts that mimic bankruptcy because they allow for a majority of creditors to bind the minority.

The traditional problem is that they do so within the four corners of that bond issuance. So it’s relatively easy for a creditor to get a controlling position in the bond issuance and neutralize these clauses, which in fact happened in the context of the Greece restructuring, which can create its own adverse dynamic.

So the big initiative has been, or one of them, has been to basically try to come up with a collective action clause which aggregates claims across instruments. So essentially it neutralizes or sufficiently dilutes the capacity of a creditor to disrupt the process. And what’s interesting is that we’ve been able to actually reach closure on key features of clauses that would embrace this feature and what’s also quite extraordinary is that these clauses have already found themselves into bonds governed by both New York law, Mexico came forward, and also by English law, with Kazakhstan.

So I think there’s been tremendous progress in this area. I think the fact that creditors viewed it as a priority is significant. I think it reflects the fact that ultimately there’s no shift of legal leverage from the debtor, from the creditors to the debtor, but rather from individual creditors to creditors as a group and that’s one of the reasons why it was acceptable.

It’s at one level an incremental change, because it only applies to new debts and we have an outstanding stock of about 900 billion, a significant portion of which only matures after ten years. So it doesn’t address the outstanding stock. Only a statutory approach could do that and the Fund has made it very clear that in this area the reforms that we’re proposing on the basis of contract as a market-based approach.

So on this first issue, this closing mechanism, I would say significant progress, not a silver bullet, but as far as we’re concerned, I think that essentially we’ve made more progress than we had originally thought we would do in a shorter amount of time, particularly because they’ve been taken up by the market without any adverse pricing.

The second issue is on the trigger, when to initiate? And in contrast to the legal framework where the Fund is trying to facilitate an agreement between debtors and creditors on how to contract, this actually involves effectively the Fund looking at its own lending policy and over which we have control. That doesn’t make it any easier though in terms of trying to implement reform. And we’re at a much earlier stage of discussions and
the views expressed by the board on the initial paper have been wide-ranging.

So let me just sort of give the context. Why is lending policy the effective trigger? Well, when a country enters into debt distress and loses market access it inevitably comes to the Fund for financing. And whether or not a Fund-supported program triggers a restructuring will depend on whether or not the IMF will condition its access on a restructuring or whether or not it will provide financing without it. Often therefore, the Fund’s decision on the conditions for its access effectively become the catalyst for the initiation.

And some history on this, the Fund had been addressing this issue for a number of years since the Mexican crisis, where there were requests for large amounts of financing and relied on what we called its exceptional circumstances clause which allowed us to provide large amounts of financing, which is normally what happens in capital account cases, where we basically believed that on balance it was the least cost approach, both for the country and for the system.

I think it’s fair to say that after what happened in Argentina in 2001 the Fund decided to have a more disciplined approach. There was a concern that the disbursement that we made, in particular in the fall of 2001, delayed a restructuring that essentially many believed had become inevitable, that at that stage effectively Argentina’s debt was unsustainable and that providing financing without a restructuring in that context was not good for the country, not good for the Fund and not good for the system.

So there was a large debate about how to impose this discipline. And without stylizing it too much, I think there were two options put on the table. One is what I call the hard, automatic approach, which was just essentially have firm access limits and when a country came to the Fund, if its request exceeded access, the Fund would not provide, financing which essentially would require the financing to come from a restructuring.

The other approach, which was ultimately adopted, was an approach which had a form of what we can call constrained discretion. And the idea was to preserve the flexibility, to provide financing, indeed large amounts of financing, in circumstances where notwithstanding the debt distress, the loss of market access, there was a view that fundamentally the debt was sustainable and that the problems were caused either by exogenous shocks, by perhaps a policy mistake, but the Fund had confidence that essentially, the situation with the Fund’s support and a strong adjustment program would turn the process around.
So the idea was that we would have lending based on a criterion of sustainability. So the rule was the debt had to be sustainable but the judgment was that sustainability is not a science, it’s an art. So there was a recognition that there would need to be a considerable amount of judgment in the application of this criterion. And over the years, the Fund has tried to refine its analysis through debt sustainability frameworks.

2010 comes along and we have Greece and it’s fair to say that Fund’s staff did not have confidence that this criterion on sustainability could be satisfied. There was no high probability that the debt was sustainable, which is the standard that’s required. So in that context the framework was amended to introduce a new rule, that in some respects is orthogonal to the sustainability access, which is that notwithstanding concerns on sustainability we can provide financing in the absence of any debt restructuring where there’s a concern about spillovers and of course, there was a significant concern about spillovers in the Eurozone in 2010, as you know.

So, that’s the framework. That’s the access framework that we are in the process of reviewing. And our thinking on possible changes to that framework are outlined in a paper that was issued in June of last year and I think it’s fair to say that there is no suggestion that we move away from the principle of constrained discretion and that the underlying criterion should be that of sustainability.

We’re not suggesting absolute caps or anything like that. What we are proposing are two changes. One is to eliminate the systemic exemption that was introduced in 2010 and this is based on several considerations. First, there is the issue of consistency with our mandate, which is the Fund’s primary obligation is to help countries resolve balance of payments problems to the extent to which it’s exacerbating those problems by continuing to delay our restructuring and providing more financing which has to be repaid on non-concessional terms to the Fund. It’s not actually helping the country. It’s actually exacerbating the balance of the payments problem. And although clearly systemic considerations are always a concern for the Fund, I think there’s a concern that it cannot compromise this underlying obligation of helping individual countries for the system.

The second is that, at least as designed, it’s not clear to the staff that the systemic exemption actually achieves its objectives of addressing contagion. We are preparing a paper that will look at this issue, will look at the underlying causes of spillovers, the channels of spillovers, how the adverse consequences can be contained. And you’ll be happy to know that this isn’t a work that’s not being led by lawyers buy, by economists. My
colleague, Hugh Bredenkamp is here, who can elaborate on some of the analyses, the review of literature on this issue.

But in essence, the conclusion is that if there are spillovers they arrive from debt distress, whether or not a debt restructuring occurs. And the spillovers will only abate, the adverse spillovers, if that underlying cause of debt distress is resolved. And if in fact a program for the Fund does not resolve that issue because there are underlying concerns regarding sustainability, it’s not clear that basically such a program will actually address contagion.

As we have discussed with a number of creditors, there has been a historical concern that while in these cases some creditors end up getting paid out and leaving, other creditors with longer term maturities don’t and there ends up being also a form of structural subordination, because the new debt that comes in, the official debt is essentially senior, so when that restructuring eventually comes, which often it will, the full burden of the debt relief falls on those rather narrow shoulders.

Now, I think you will see that the paper that we’re writing will point out that we accept the fact that there may be circumstances where the official sector understandably wants to avoid any form of debt operation because of systemic consequences. What we’re saying that in those circumstances, the best way to do it is for the fund to provide financing in conjunction with concessional financing by those members that are most affected by the contagion but the concessionality is designed to address the underlying sustainability concern.

Now, this doesn’t mean that we need to have a new concessional financing facility. What we’re looking for is a political signal from countries that they’re willing to take measures that will address the underlying concern on sustainability because we believe that that’s the only way to resolve the uncertainty.

My final point on the second aspect is we want to create a little bit more flexibility to the framework that was established in 2002. I mentioned that the requirement is the debt must be sustainable with high probability. Now, we think that this makes a lot of sense and that when you have a country that clearly has unsustainable debt you need to have a debt operation that delivers that outcome. We’re interested in outcomes, not in specific operations. We want to have a debt restructuring that delivers that outcome. But where you’re not sure and there are circumstances where there is uncertainty because this is not like the corporate context, the line between illiquidity and insolvency is not straightforward.
Where you’re uncertain requiring an operation that actually is definitive, that gets you to an outcome of high probability may not be the least cost approach. What we would like to be able to do is in those circumstances, to have the flexibility to support operations that although don’t change the debt dynamics in any fundamental way, essentially provide insurance by having a short extension of maturities with a limited NPV impact because there would be generally no reduction in coupon or principle, so that if in fact the country was able to make it to sustainability through adjustment, fine. But if it couldn’t, at least there would be a broader creditor group, a more flexible creditor group, that would be able to absorb the restructuring.

And we actually also think, this is my final point, that on balance this would actually, relative to a program that just bails creditors out, this could actually improve sustainability because it provides additional financing to support a less constrained adjustment path and also because the creditor group is private, it might actually accelerate return to market access because of the concern regarding structural subordination.

So, the bottom line, no fundamental changes. Actually, we’re trying to go back, in some respects, to what we were doing before the systemic exemption. We survived for many years without it and we think it might be better to go back to it. And secondly, we’re trying to introduce some degree of flexibility. So I’m sorry, I’ve abused my time. Thank you.

Adam Posen: You abused it with beautiful substance so I will let you get away with it. Thank you very much, Sean, for setting things out so clearly, so forthrightly and giving us a good understanding of both the intent and the proposal. Adair, we turn to you. You’ve done work with MGI, McKinsey Global Institute, on the broader issue of public sovereign debt. How do you see the issue in broad and where does this fit in?

Adair Lord Turner: Good. Adam, thank you very much. It’s a great pleasure to be back here at Peterson Institute. I mean, Sean has talked about the structures for the future, both as to the nature of the conditionality of lending and also the way that we deal with problems in the future by better contractual design. But in the middle of it you mentioned on [inaudible 00:30:12], I noticed a reference to outstanding stock, which is there already and it’s the outstanding stock that I want to talk to and say some points about.

This document, the McKinsey Global Institute document on debt and not much de-leveraging, and the fundamental thing I’m going to say on sovereign debt, though I think it also applies to private debt, is that the accumulation of stock which we have in the world at the moment includes significant amounts which are unsustainable and will not be repaid in the normal sense of the world repay.
The basic fact is that over the last seven years in the advanced economies, the total level of public debt has gone up on average from 69% of GDP to 104% of GDP. And of course one might think, what a lot of prolific governments that is who beat out their borrowing money. But the crucial thing to understand about where this came from is that across most of the world it has derived as a knock-on effect of a prior expansion of private credit.

Private credit in the advanced economies grew continually over 60 years from 50% of GDP in 1950 to 170% by 2007. That along with some features within the financial system then produced a crisis and after that crisis, we entered a period of attempted private sector de-leveraging, which depressed nominal demand, depressed economies, and made it inevitable and sensible that governments should run large fiscal deficits to offset that de-leveraging depression. But with the inevitable consequence, which is the absolute core message of this report, that the debt hasn’t gone away. It has simply shifted from the private to the public sector.

And indeed, if you look across the world and this was also set out three months ago by what’s called the Geneva Report, who also did this analysis, we find that there has been a limited amount of t private sector de-leveraging but for every percentage point in private sector debt there has been a bigger increase in public debt and total debt, private and public combined has simply gone up. And as I said, I think you therefore have to understand the increase in public debt, in particular in countries like Spain and Ireland, less so perhaps in Italy and Greece, as fundamentally deriving from the private sector credit boom which laid before.

Now, I believe that the amount of public debt which now exists in several countries is at the level which will not be simply worked out in the classic sense of repaying debt and that also was the conclusion in the paper by Carmen Reinhart and Ken Rogoff in November last year based upon a historical analysis of debt repayments, based upon expectations of what are likely real output growth rates and inflation growth rates and therefore the feasible level of the growth of the denominator, nominal GDP. If you put all that together it’s simply not credible that a large amount of the debt which is out there is actually going to be repaid.

Let me illustrate that with two examples, first Japan. Now Japan should have been the canary in the mine of the problems we were going to face after 2007 because they faced them from 1990 onwards. They had the private sector credit boom back in the 1990s. They had the balance sheet recession thereafter and they now have gross public debts of 230% of GDP.
There is in the document that the IMF produces each year, *The Fiscal Monitor*, a nice piece of analysis which illustrates what is required in order to pay down that debt. And the scenario shows what Japan would have to do in order to reduce not gross debt, but net debt of 140% to 80% by 2030. And the figures in the latest *Fiscal Monitor* say that in order to do that they will have to switch over the next five years from a cyclically adjusted primary balance of minus 6% to a positive of plus 6% and maintain that ever thereafter. Now I will not bet many things in life but I will bet you that that is not going to occur. I will bet you that if attempted it would tank the Japanese economy into a far deeper recession where the denominator would fall and we'd get no de-leveraging at all.

But that is not just the situation in Japan. The IMF *Fiscal Monitor* and also a variance of this analysis in the *McKinsey Report* also show the level of the primary surpluses which Spain and Portugal and Italy and Ireland and Greece would have to run. And as Barry Eichengreen argued, pointed out in a recent article, think about this being permanently at about 4% for Ireland, about 5 or 6 or even 7% for Spain and Italy and Portugal and 7% or more for Greece.

Now you may say, "Well, those are just—that’s just the scenario. We don’t really believe it." But actually in the European Union, the Eurozone debt break, that scenario has been turned into a legal requirement to bring down the debt to supposedly sustainable levels.

So I’m saying that debt burden will not be reduced by the classic process of turning a primary deficit into a primary surplus big enough to pay down the debt. So what is going to happen? I think we have to draw a distinction between those countries which are their own currency issuing power and which have issued the debt in their own currency and therefore where private-public debt sustainability is ultimately, ultimately underpinned in nominal terms by the fact that the Central Bank can if it wants, monetize the debt and those which are in a different position.

Now the different position of course includes developing countries which have issued debt not in their own currency, the classic problem of debt sustainability from the literature of the 1970s and 80s. But I’m not going to talk about that. I’m going to talk about Japan and the Eurozone.

What will happen in Japan? Japan is going to permanently monetize its debt. At the moment Japan has about a trillion of debt outstanding of which the Bank of Japan owns 200 billion. The Bank of Japan is buying the debt at 80 trillion a year. The government of Japan is issuing it at about 40 trillion a year. The amount of debt which is not held by the Bank of Japan is declining. By 2017 at the current pace the Bank of Japan will hold almost 100% of Japanese GDP in debt, in government debt and I will
assert that it will hold it permanently, that the government of Japan did not do what Ben Bernanke told it to do in 2003, do a helicopter money drop, but it is essentially taking a post facto operation which turns those previously funded deficits into a helicopter money drop.

The problem in Europe is you can’t do that because the European issuers of sovereign debt are not really sovereigns at all. Charles Goodhart, Professor Charles Goodhart of the LSE, has a wonderful phrase about European sovereign debt. He says, "This is sub-sovereign debt." You have to think about the debt of Spain and Italy and Ireland as being the equivalent of the debt of the State of California or the State of Illinois. It is debt issued by people who don’t issue their own currency and don’t have a central bank which can ultimately buy it.

So what will occur? Well, it is not all going to be repaid because there will be either of two things, which means that people can walk away from the debt. There will either be a set of political reactions where this debt becomes simply unsustainable, politically unsustainable, and this is the point that Barry Eichengreen in his article, that it is not believable that these countries are going to have the political will to sustain these primary surpluses over multiple years and we are a long way away from putting behind us the radical populist political movements in Europe which want to reject some of this debt. Or let us remember that individuals can always walk away from sovereign debt, particularly if they are members of European Union which has free movement of people. It is not a rational point of view. It is not a rational action for a young Greek person to stay in Greece, accepting the burden of taxation required to repay these past debts and they don’t have to stay there. They can move to Germany and pay only the taxes required to repay German debts.

So my conclusion is we have a level of debt within the European environment, well, we have a lot of debt, sovereign debt across the world which will not be repaid in the normal sense of the world repay. In some countries and in particular Japan it will be permanently monetized in some, and in particular, the peripheral countries of Europe, I think we have not got to the end of the issues of debt restructuring.

Adam Posen: Thank you very much, Adair. I will resist the urge to make any comments on Japan. I will just say a couple things. The report, hold up the report please, Adair, copies of this will be available outside and available for download from the event along with the—on the event page on our website—you can put it down now—along with a smattering of our writings on this issue.

I would just point out apropos of Adair’s comments on Europe, last year we published William Cline’s book on a different form of doing
assessments of scenarios in Europe and European debt with a methodology of looking at co-movements and growth rates and risk with debt scenarios. He comes out mildly more optimistic than Adair does and I would urge you all to look at Bill’s work on our website. And also, a recent policy brief by our newest Senior Fellow, Paulo Mauro, who talks about the fragility of the ability of governments to pay off their debt going forward as growth rates get downgraded, both of which I think are useful complements to what Adair was saying.

Let me now turn to the aforementioned admirable Anna Gelpen, to bring us back to some of the issues Sean raised and she is in a position where she can speak as she has written about Argentina, Ukraine and the applicability of these things and I hope she will.

Anna Gelpen:

Thank you very much, Adam. It’s a privilege to be here. It’s a privilege to comment on the Fund’s recent initiatives. And I want to just open by saying I am a big supporter of what you’re doing and by saying that up front I hope to give myself a little leeway to be a constructive supporter.

So I want to open with some background, which is that we have to just stand back in awe at the unprecedented breakthroughs and reforms we have seen just over the last few years in sovereign debt. We have had record-breaking bond restructurings that have gone relatively smoothly. We have had unprecedented contract reforms, which Sean has already mentioned.

Now, to see how important this is you have to think about the fact that the League on Nations in the 1930s started advocating some of these reforms and for decades nothing happened. The G7, the Treasury, the Fund, worked on this in the mid-90s, early 2000s. What has happened over the past year is truly astounding and I think the Fund and the market participants and the Treasury certainly deserve massive credit for that.

We have also seen judicial decisions that for the first time in modern memory raised the prospect that sovereign debt could be enforced in a replicable generalizable way. Right? So you can only find so many tall ships to seize and fewer to sell but payment flows are everywhere and the contract clauses that got Argentina into trouble are also everywhere.

Finally, we’ve even had a treaty framework in Europe that specifically addresses debt restructuring, so this is really just an incredible wave of reforms. And yet Greece is on the edge of another, call it what you will, within just a couple of years of the biggest and arguably most successful bond restructuring in history. After the unprecedented court victories for creditors Argentina’s defaulted debt was not paid, in the conventional or
any other sense of the word, but has tripled. No one is getting paid meanwhile Granada and Ecuador were fighting lawsuits from creditors.

Ukraine has hired advisers, just within months of having its debt declared sustainable with high probability asterisk subject to geopolitical contingencies. Meanwhile, the UN is negotiating a framework for sovereign debt restructuring. So this is a time of turmoil and all this to say that the IMF’s policy review comes at a critical time and what the Fund does is going to be very important, no matter which way it all comes out.

For better or worse, the IMF is the glue that holds together a fragmented, convoluted debt restructuring process. Sean has alluded to this and I’ll revisit. The debt sustainability assessment effectively sets the parameters of restructuring or not a restructuring. The program sets the reform conditions. The lending policy, really the exceptional access policy, creates the incentives for debtors and creditors to come together and the scope for compromise.

Now the Fund wears multiple hats. It’s an adviser, it’s an analyst, it’s a creditor, it’s a membership institution, and of course, it’s a guardian of systemic stability. Therefore, it is essential for Fund policies to be credible and to be seen by the markets and by the people for whose sake it is all being done as credible.

Now credibility comes from process and credibility comes from outcome. The process must be intelligible and predictable and the outcome must be sustainable. From the standpoint of both process and outcome, in my view, it is simply not credible for a membership organization on the front line of international financial crisis response to operate in a thicket of detailed rules and arcane terminologies that are creating like barnacles on an old boat.

More rules doesn’t mean better rules. These rules will be broken and engender further distrust. This cannot turn into a vocabulary contest where new terms are being debated every quarter, whether again, we are talking about repayment and re-profiling in the normal sense of the word or any other.

Therefore, I am delighted and I really welcome the return to flexibility in the IMF’s crisis response, that the proposal, that the recent proposal for lending a framework reform represents. If a government comes to the Fund for extraordinary support the IMF should be able to ask other creditors, public and private, to share in the burden of resolving this crisis in an equitable way; period.
I also welcome and I think it is wonderful, that the systemic exemption is on its way out. I think it is an embarrassment. Now, I want to flag that this is quite apart from whether it should have been used in Greece. Right? Whether something is done in an emergency is in some sense, a separate judgment, but lending to a country that is already in over its head for the sake of bigger countries next door should not be sanctioned as part of regular policy.

If it happens and it still might, whether the exception is there or not, it should be a visible departure from the rules and it should be a wake-up call for the system and in some ways I’m very glad that what happened here turned out to be such a wake-up call. So again, I’m delighted that the systemic exemption is on its way out but I do think that in order for that to be credible you need a backup plan to address contagion and I’m delighted at the work stream that Sean described.

On the other hand, I am befuddled. I continue to be befuddled and a tad distressed, by the introduction of new categories than vocabulary words, like re-profiling rather, as distinct from restructuring. New triggers, such as sustainable, but not with high probability maybe or maybe not subject to geopolitical contingencies and sunset on the East Coast.

The caging language, the use of words like normally and generally that you will see cropping up in these policies, I think betrays the discomfort of the proponents of new vocabulary words and new soft constraints. I think this is a recipe for obfuscation with more opportunities for manipulation and distrust. What is a category of sustainable but not with high probability? You’ve got two variables here, sustainability and probability, go figure. How would normally without any reduction of principle and interest be implemented? Perhaps more importantly, how would it be understood? How would it be price predicted?

To be clear, I do not doubt that maturity extension without principle reduction can be a good idea, a much better idea perhaps than principle reduction in any given case or in most cases. I don’t even quarrel with the preference for maturity extension in many cases. What I dislike is the appearance of detailed pre-commitment. I think that any such, sort of anybody who thinks this is a pre-commitment and a predictable path forward would probably be disappointed.

Now what should be done? I am a big fan of simple rules that are visibly broken, so I actually think that it should be clear by now that any request for exceptional assistance from the public sector might or might not occasion and exceptional request to change the terms of the debt. Right? And anyone who says this is all about sovereigns I think is mistaken. Just look at GM bankruptcy. Right? When the government comes in, rules
whether they are in statutes or in decades of practice, funny things happen to rules in that circumstance.

Therefore, I think it would be much better for the Fund to stick with the policy of case-by-case but to provide a detailed contemporaneous justification and exposed assessment of the burden sharing strategy, something that is already on the way to doing with reforms to DSA and others. Constituents in the market and very importantly in the street, can make up their own minds about whether this is right and what it means for them. I think anything else is probably a mirage that would do more harm than good.

So with that, again, I am grateful to be here. I just want to reiterate that I’m a big, big supporter of this new path and congratulations.

Adam Posen: Thank you very much, Anna. Turning now to Ángel Ubide. There are two things I neglected to say when introducing him before. First, he is a Veteran of the Fund, having been there during the Asian crisis and worked on, I believe, the Korea program and so comes to this not as a pure market person. But secondly that we are very fortunate, just as Anna helps us bridge the gap between economics and law, Ángel has helped us bridge the gap between market behavior and macroeconomics, which is always a bridge too far, but he tries. We’re grateful to have Ángel getting more involved with us as time goes on and I turn to you for your views.

Ángel Ubide: Thank you. Let me just say that Anna just said that the Greek debt restructuring has been the most successful debt restructuring in history. And I think after learning that, I don’t know if we want to continue to discuss changes to the framework for debt restructuring at the Fund, but anyway.

Let me start by saying that it took me three reads to understand what the paper says, even though I did work at the Fund and I did provide comments on the first version. So let me try to give you the summary of what I think the paper is doing. Right? The paper tries to say two things. The new policy implies that countries will be allocated in three buckets if they ever call the Fund and they need exceptional access. Sustainable with high probability, you get a program. Sustainable without high probability, you go to re-profile. Non-sustainable, you have to restructure.

Let me note that in two of these three events there would be a serious event and this is something that I think needs to be remembered. The second point is that the systemic exception would be eliminated, although the paper essentially agrees that what was done in the Euro area would be a viable option. In other words, if you want a systemic exception you
come and pay for it and then the Fund would contribute basically following the rules that it has.

Now my main worry, and just to give an example here, is that everything hinges on the definition of sustainability with high probability and nobody knows what that means. It’s not explained in the paper. I would respectfully disagree with almost everything Adair Turner said about the sustainability of debt in the world today. And if that gives you two views on what is sustainable then I think there are going to be many views on what is sustainable out there.

It’s a bit like a central bank announcing that it’s going to adopt the price stability target, but doesn’t define what price stability is or provide a numerical value for the target. It’s very difficult to follow. Now, when you want to put that into a policy I think it can create more problems than it solves.

Now, the paper has two interesting contradictions. The paper said that the new lending policy would accept re-profiling as a condition for exceptional access, even if it doesn’t restore sustainability with high probability. At the same time it says it would accept concessional assistance as a condition for exceptional access because it would restore sustainability. So it would be willing to provide exceptional access with or without the debt being sustainable with high probability.

The same applies to—back at number one, I will give you exceptional access if you’re very sustainable with high probability or back at number two, I will give you exceptional access if you re-profile, even if your debt is not sustainable with high probability.

So what is the conclusion from this? I think what this means is that the ultimate objective here is essentially to increase the probability of private sector involvement and reduce the expected use of Fund resources. And I continue to disagree with this fundamental point. I think at the end of the day, the Fund lending policy should be to maximize its effectiveness during a crisis and should not be based on the amount of balance sheet that is deployed.

Now, this new policy would want to eliminate the systemic exception. Let me just walk you through the three arguments that it uses in the paper. The first one is moral hazard and I continue to think that you deal with more ex-ante, via more information on sustainability, naming and shaming and other things rather than ex-post. It claims that it’s too narrow that it would only apply to a few countries. Well, that’s just the way it is. Not everybody can be sustainable. Now, maybe those systemic countries pay ex-ante for this insurance, have heightened surveillance, have more data
disclosure. It’s a bit like demanding extra capital to SIFI if you think about bank regulation.

And then it says that it’s too broad. Well, that’s precisely the point. You want to address the unknown and known that is why the Federal Reserve have 13(3) and that’s what I think the IMF should have the systemic exception. You don’t know what’s going to happen one day. It is at the end of the day impossible to define ex-ante what is systemic. I don’t think anybody felt Greece would be systemic. I don’t think anybody thought Ukraine could be systemic. I have no idea what’s going to be systemic in five years. And so you could define a systemic exception as an option with positive expected value and I don’t see why we should get rid of it or at least I need stronger arguments to be convinced that we need to get rid of it.

Now, one of the things the paper does is to say at the beginning that the presumption of re-profiling is not there. Now, it is not their own paper, but I have to say that given the high levels of debt in many countries, given what Adair Turner just told us that in many countries the debt is going to be unsustainable and given that the quotas have not really increased in the last several years, I would bet that there is a de facto presumption that whoever calls the Fund, especially if it’s a big country, is going to be subject to re-profiling or restructuring.

And so if you continue with this logic then the probability of calling the IMF and then CDS triggering increases under this kind of policy and this is something that is going to create potential domino effects. I commend the Fund for insisting that there is no presumption de jure, but I think de facto the presumption remains.

Why do I think this? Because we need to be convinced, and let me put my market hat on the power of anchoring in financial markets. Right? Why did we have the problem we had the last five years in the Euro area? Because of the anchor of PSI. The moment the process of PSI started everybody started to price Spain and Italy under the probability of a restructuring. Now we have the same problem with the anchor of Grexit, which is a word I don’t like, but I’m using because everybody understands. Why are we saying that the only option to Greece agreeing to a program is to leave the Euro? Well, because it has become an anchor and that anchor is now pricing all Greek assets.

This would be a similar thing in terms of creating the anchor or re-profiling. Now, you would tell me that the markets would only price restructuring or re-profiling if there is a fundamental reason to it. Well, think about the different one. Why do you think that the day the Swiss National Bank decided to drop the Euro-Swiss floor everybody started to
bet that the Danish National Bank would have to leave the Euro-Danish krone floor? It’s called anchoring. There was nothing fundamental about it. It’s not that all of a sudden people woke up on a day and said, "The Danish currency is overvalued or undervalued or anything else." It’s the power of anchoring. That’s the way markets work.

So the paper tries to evaluate the beauty of re-profiling based on the speed of return to markets. I think that’s incomplete. It should evaluate based on the impact that re-profiling could have on growth on the country that requests assistance and then think about the impact of the tightening of financial conditions.

Now, if I take that argument a little bit further sustainability is basically an endogenous concept. Right? It’s endogenous to the policy that the country is willing to adopt, essentially their willingness to pay. And so we need to think about time to [inaudible 00:59:53]. Imagine this policy had been in place in 2010. My bet is that Portugal and Ireland would have been found sustainable with low probability and that would have triggered and automatic re-profiling or the automatic pricing of re-profiling in several of these countries.

Now, do we think they are sustainable today? I have no idea. I guess we can agree to disagree on that, but we need to think about these issues. How many type two errors could have been made in the past if this policy had been put in place? And I think we need to consider one thing. I know the report says, The McKinsey Report, says there is too much debt. Let me offer an alternative view.

When markets are priced in negative interest rates, I think markets are saying there isn’t enough debt. There is an excess demand for debt instruments that guarantee the repayment of a principle. Now, if you were to at least take this view half seriously you would think that you don’t want to mess with the integrity of assets that promise the repayment of the principle and then you can about different ways of solving these problems.

So let me make a couple of suggestions. The first one and that’s where I take Anna’s line, if it’s not broken, don’t fix it. I think the option of re-profiling is always there. The case for too little too late restructuring is very weak and I would frankly, want to have a systemic exception in however legal form. If the current one is not the right one, then let’s find a different one, because the objective should be to minimize the GDP cost of a crisis, not the use of the balance sheet of the Fund.

Now, I wouldn’t want policies to be made based on two cases, that were Argentina and Greece. This is not the way to think about policy. Policy should be done looking forward. If I can make the parallel with the Fed
here in the US don’t repeat the mistake in Dodd-Frank of limiting the powers of the Fed in a systemic crisis. Don’t fight the last political war. Look ahead and think about the future.

So I think one homework that the Fund could deal with is to define sustainability better and I know it’s not easy but there is a concept out there called fiscal fatigue that some people at the Fund have been working on, essentially to define what is the plausibility of the debt stabilizing primary balances that a country would have to adopt in order to achieve some level of sustainability. You can create a Fund chart with these primary balances. You could have a table that every six months places each country of the world or each member country of the Fund, into each of the three buckets. And so markets would be able to define at every moment in time what that country is and if you are willing to do that, then I think this policy would have a chance to work. Thank you.

Adam Posen: Thank you, Ángel. I’m going to open it up. We have some very knowledgeable and distinguished people in the audience for discussion, but first let me give Sean if in three minutes any particular points raised you want to respond to and then you’ll get more opportunity later.

Sean Hagan: Sure. Thank you, Adam. I, first of all, I want to thank my panelists for having made it through the paper, in some cases three times, and for their constructive comments.

I think at least I see the issues, there are three issues, at least the way I divided it. First of all, do you think that our lending should be premised on some assessment of sustainability as the overarching consideration? My sense is, even from Ángel, that the answer is yes, that we don’t want lending to be based on geopolitics or anything else. We should be looking at whether or not, in the final analysis, this debt can be repaid. So we have to do some sustainability analysis and I think I would be the first to admit and my colleagues here in the room, the economists who I work with at the Fund would also agree, we need more work. There’s more work to be done on improving. I think a lot of progress has been made, both in terms of transparency, but clearly more work needs to be done.

The second point is that, okay, if sustainability is going to be the thing that we look at, is it appropriate that we calibrate our response taking into account where on the spectrum a country is on this sustainability? That’s all. If we actually think that they’re very sustainable we don’t actually think a restructuring is needed. If we agree on that, all we are saying in this paper is that the 2002 framework needs a tweak because right now unless you’re sure that debt is sustainable, unless you’re really sure, you have to do a debt operation that actually changes the fundamental debt dynamics and get you there. We would like to introduce some flexibility
so that in circumstances where it’s not as clear, you can get time to give you more time. You can actually do an operation that’s not definitive but provides some insurance. It’s an additional tool that we would have in those cases.

Now, based on the discussions that we’ve had with market participants on this, I don’t think that really there’s any objection that we’ve seen to that. Now, have we perhaps—we need to look at this to make sure that we’re not confusing people because we’re focusing on outcomes, not on specific operations and not on vocabulary. We just want to increase flexibility so that our lending framework is mapped more closely to the reality of the spectrum of debt sustainability, rather than being binary. That’s all.

And the final point is, so the question is do we want flexibility along that spectrum? We think it’s a good idea. Our sense is that most market participants think it’s a good idea, but clearly, we need to convince people that we’re simplifying things, not making it more complicated.

And by the way, it’s all going to be case-by-case. This idea of case-by-case versus rules, we all know that any debt sustainability is going to be case-by-case. That’s not the issue. The issue is do we want a conceptual framework that informs how we resolve those cases?

Adam Posen: Thank you, Sean. That was your final point you said. So, I’m going to open it up to the floor. As usual, we have a traveling mic from Jessica in the front. We have a standing mic in the back. I will recognize you. Please identify yourself before asking what should purport to be a question. Jessica, if you could go there, but first the gentleman at the back mic.

Irv Chapman: Thank you. Irv Chapman from Bloomberg Radio. A question for Lord Turner. There you are in Frankfurt with the chairman of body politic is 180 degrees. The other round from the Greek body politic. So are Germany and Greece in a permanent collision course? And this week in Brussels with Greece, what’s happening? What should happen? And what do you think will happen when the finance ministers go home?

Adam Posen: How lovely and on topic. If I could ask Adair and then Ángel, to just give a concise response to Irv.

Adair Lord Turner: Ideally in economic terms, I think there should be some Greek restructuring. I don’t think this debt will get repaid in the normal sense of the world repay and I think if there isn’t some significant degree of restructuring and reduction of the net present value Greece will leave the euro. Now, that might be the optimal thing to do and I think almost certainly that on the German side, there will be people who will say, "Well, don’t blink. That would be a better result." The only thing I’m
absolutely certain of, I do not think that Greece is about to turn into a country which achieves as the plan is meant to be, a 4% primary surplus in 2016 and runs that effectively permanently ever thereafter. I just don’t think that that is going to occur and I don’t think that that is an optimal policy.

So I think the issue if both sides don’t blink Greece will leave the Euro. I’ve always thought the most likely result is, and it gets to this great re-profiling debate changing the interest rate, one of these games where you increase the maturity, you reduce the interest rate. It’s always interesting to work out, if you take that to its logical extreme, which is a perpetual non-repayable debt at 0% interest, it will always be sustainable but you can still tell yourself that you haven’t reduced the face value of the debt.

Most of the calculations are you can take about 17% of Greek debt down by those sorts of games in a defensible point of view, i.e., maturity extension, which is not absurd, a reduction of the interest rates to a set of other reference rates, which are not bizarre comparators. I’ve always thought that’s most likely the result but at the moment, I’m not sure.

Adam Posen: Okay, Ángel, briefly, then we’ve got, Hung. The gentleman at the very back, if you’ll go to the mic. I’ll recognize and then Doug.

Ángel Ubide: No, I don’t really have much to add. I think the key issue with Greece is to understand that way over 50% of its debt is official debt and it’s official debt with incredibly low maturities, low rates and especially, it will take many years until it has to start to be serviced. So that debt is junior to private debt. And so from the point of view of the sustainability of the private debt, I think Greece is in a distant position if they can continue to hold to sustainable policies. That’s all. They don’t need to run at 4% primary surplus for that.

Adam Posen: Okay, Hung.

Hung Tran: Thank you. My name is Hung Tran from the IIF, and thanks all the speakers for a very succinct summary of their view.

My question is to Sean. I think that you may have ran out of time to say much more about the second phase. The first phase, triggers; last phase closing mechanism. So my question is about the second phase to allow you some time to say something about it and specifically about the lending into [inaudible 01:10:27] policy, the key requirement of interest to private sector creditors is the requirement that sovereign debt has to engage in good faith negotiation with creditors when they apply. Do you foresee any change or dilution of that requirement in staff thinking, particularly in the upcoming paper?
Sean Hagan: Thanks, Hung. Yes, so I didn’t have a chance to get to this final point process and in part, I didn’t think it was a big loss because we haven’t really started our work on this area, but let me just very briefly say what our intention is.

When we conducted outreach, with respect to the market on the last paper and including the removal of systemic exemption, introducing flexibility, our sense from the market participants was that they had no difficulty with this idea of just basing our lending decisions on sustainability. Their biggest concern was the issue that you have raised, which is that once the restructuring process has started they want to have some assurance that the way in which the debtor engages with the private creditors, but also the way in which the private creditors engage with official bilateral creditors, who may also be subject to restructuring, is considered to be a fair one.

And I think that the way we hinted a little bit, Hung, on our last paper on how we’re looking at this issue, which is we want to focus on outcomes and on broad principles. I don’t think that there’s a sense that staff is suggesting that there should be take it or leave it offers, that we want to get a high participation rate in any debt restructuring and that requires, essentially, real and meaningful engagement with creditors. The question is, is the way in which this engagement takes place exclusively through a formal creditor’s committee or are there other mechanisms as well that satisfy that objective?

So we’re going to be discussing that issue in this paper and we will want to have a discussion with market participants on their thinking so that we can reflect it in the paper that will be discussed by the board, probably in the fall of this year. So we will be moving on that issue, but also on issues on how to deal with official bilateral creditors, which is also a very pressing issue. Thank you.

Adam Posen: Thank you. If my eyes don’t fail me, I believe Ian is at the back mic. Doug is next.

Ian Talley: Ian Talley, Wall Street Journal. Please excuse my ignorance here. I’m not an economist, but viewing the Ukraine and Greek situations it seems to me the credibility question is quite clear. I remember asking repeatedly whether IMF was going to request debt restructuring and I was told repeatedly that no, no, it was never considered. We’re not going to discuss it at all and of course, there were suggestions early on. Ukraine, Anna pointed out, that Ukraine’s debt is sustainable to a high level and then of course, in terms of the lending into arrears, of course the IMF puts NAFTAGAS, which is 100% state-owned debt, to the side and doesn’t include that as part of their lending into arrears strategy.
So it seems to me that markets perceive the IMF debt framework as already incredible. What’s unclear to me is why it really matters. I understand markets want some clarity about the rules of the road but it doesn’t seem to be breaking any sort of efficient functioning of markets right now in the globe. Everybody seems to be buying everybody else’s debt, right?

Adam Posen: Another way of putting Ángel’s point earlier I think, I’ll let Sean respond but I will also then want to open it up to other members of the panel.

Sean Hagan: So briefly, I don’t want to get into the Ukraine. I think that in terms of what happened with the Fund and Greece in 2010, I think the paper is relatively straightforward that we think that there should have been an earlier restructuring and that’s one of the reasons why we want to basically eliminate the systemic exemption because that was the vehicle that we used to delay that process.

My own view, and maybe this is overly formalistic, was that it would have been less credible for us to have just said, well, we think debt is sustainable with high probability, when we clearly didn’t think it was. Which is why we said we’re not going to say that because we can; so we amended the rules. We were transparent and we think that at the end of the day, you may think that that was also a mistake of introducing the systemic exemption and we agree with you in retrospect, but we wanted to basically preserve some integrity on the sustainability analysis by lowering the standard, which is what we did.

Adam Posen: Anna or anyone else? Yeah, Ángel.

Ángel Ubide: Very quickly. So why is Ukraine not relevant? Because there are no other Ukraines, right? That’s what I meant to say by the power of anchoring. The problem with rules that are defined too rigidly and don’t take it the negative way, is that there could be one day in which that rule is applied in a new situation and then it generates the domino effect. That’s why the PSI anchor was so important because all of a sudden when you realized in 2010 or 11 that the condition for any program is to restructure your debt, then you apply that framework to everybody else.

You could say the same thing in 97, 98, the first peg breaks and then everybody goes after the next ones. That’s what I’m trying to say. So in this case, it’s sort of irrelevant. Ukraine is a very specific sense, it's a very specific case, but you don’t know what the future is going to look like and I think that’s where the anchoring problem is there.

Adam Posen: Anna.
Anna Gelpern: Right, so just following up on that and I actually agree with Ángel in substance that Ukraine is unique. The problem is so is Argentina, so is Granada, so is Greece, so is Belize, so is, I mean, in a world of a couple of dozen issuers with steady market access, everybody is special. Right? I mean, there are thousands of companies listed on the New York Stock Exchange. That’s when you can talk about a sample. Right?

So therefore, going back to Ian’s question, what is a credible rule in this space. Right? What is a credible commitment by an organization that by definition, just by its mandate, is pulled into different directions and I would submit that it is not a detailed, arcane process, sensitive rule. So if I’m in the market and I’m very not, I would be really careful about hoping for the IMF to sort of run my restructuring process and to be the pressure point for the debtor to talk nicely to me because I am one of many constituents on the Fund and the Fund has no capacity to compel the debtor to come to the table. Right? Therefore I’d say fewer rules, but more disclosure, more reason justification so that a pattern can be deduced and reasonable judgments can be made.

Adam Posen: Thank you. Unless Adair wants to comment on this issue. I didn’t think so. Thank you. Doug.

Doug: Thank you. Three comments, three suggestions, primarily to Sean because you’re the representative of the Fund, but obviously for everybody. The first one is on, and I think Ángel did a great job of defining this in his statement, how do you define sustainability? The Fund I think put out a paper in August 2011 if I recall which basically said sustainability is subject to a lot of discretion depending on the circumstances. And I guess the suggestion would be, Adair mentioned, if you had a zero coupon perpetual for Greece the country would be sustainable. And I guess my question is, is that true under the Fund’s policy of seeking 120% of debt-to-GDP? Because actually the total amount of debt outstanding would not decline and so actually, even under a zero coupon perpetual scenario, if you don’t do something to the definition of sustainability you’re still not sustainable under that metric.

So question number one or comment number one, is go back to the August 2011 paper, the definition of sustainability seems to me to be the key point here. Everything else on the left side of the equal sign has to actually reconcile with the right side and the discretion.

The second point is on the systemic exemption and I’ve raised this with you, Sean, in the past, but it does seem contextually about making each country unique. The question I have is under the Fund’s articles, which require you to do what’s right for each individual country, how do you
reconcile that when a country is part of a monetary union? Because that is why Greece ended up triggering the risks of contagion. It wasn’t the unique nature of Greece; it was the unique nature of a monetary union. So I’d encourage work being done on reconciling the articles requiring you to do a country-by-country analysis and countries that are in a monetary union.

And the third is on transparency, where the Fund did a great job about a year or two ago of coming up with the template and the heat map, which were made publicly available so that the market could make its own assessment of sustainability. However, in actually trying to use that template, what I have found and others I know as well, is it’s virtually impossible to do so. So it’s out there but it’s actually not usable. So a question, how do you make it easier to access and could you have the Fund actually impose, sort of input the assumptions they make so that markets can easily toggle around with their assumptions and then make the heat map and the template more usable for the markets to make their own independent assessment?

Adam Posen: I’ll ask my colleagues to, no disrespect to Doug, to skip over sort of the software upgrades on the interfaces. That’s not our thing. But on the other two issues I’d welcome anyone’s comments. Obviously, Sean wants to speak but is there anyone else before, yes, Adair, please.

Adair Lord Turner: I just want to make one comment provoked by what you said about the appropriate role of the IMF with a country within a monetary union and I want to make the argument that in an ideal world the IMF should have had nothing to do with the Greek problems whatsoever, that if you accept that the Eurozone is essentially a system which makes the individual nation states like State of California or State of Illinois, I mean, the IMF would never get involved in the debt sustainability of Detroit or Illinois or San Francisco.

It is a dysfunctional system because the Eurozone is as if in US terms, there were no Federal debt. All the debt is the level of State of California, State of Illinois, State of New York and is equal to 100% more of their GDP. With the banks, which happen to be located in Illinois or California holding as their liquid asset reserves undiversified portfolios of the debt issued by that state, which could not be worse in terms of wrong way risk, correlated risk and it has to change radically.

By the IMF, with normal rules of game, getting involved in Greece, it was one of the things that stopped the radicalism of the changes required. It would have been much better at some sense, if the IMF said now that you’ve had the monetary union that’s your problem, because that I think
would have forced the Eurozone to grow up and face the really radical changes which are required to make it a successful monetary union.

Adam Posen: Fiscal transfer is good. Debt, bad; fiscal transfer is good. Sean.

Sean Hagan: Yeah. I mean, just Doug, on your question, first of all on debt, debt-to-GDP ratio is not the only dimension to the debt sustainability analysis and even on that dimension, 120% is not a magic number, but [inaudible 01:23:30], who is sitting right behind you, is the person who basically runs the DSA analysis. So you should make suggestions to him as to how it can be more accessible.

On the issue of basically to what extent can we essentially provide assistance to a country in a monetary union? Well, I mean, in some respects this is less different than you think. You do have countries that still have balance of payments problems. One of the issues that came to the fore in the Eurozone crisis was the current account deficits that we’re being run by these countries, the lack of competitiveness. And I think that, and this is something that will be brought out in the paper that will be discussed shortly, is that even with integrated financial markets, the premise that you actually are doing the Eurozone a favor by delaying the restructuring of the sovereign debt is questioned. That’s the point. We don’t concede that in a highly integrated market delaying a structuring that needs to take place is actually good for that Eurozone. I think the paper you’ll see takes issue with that premise.

Adam Posen: It very clearly does, and again, I’m worried I’m being too facetious. I happen to agree with Adair on fiscal transfers as well. I think those are very important points. Unless Ángel or Anna wants to come in, last question of this session will go to Ted Truman.

Ted Truman: Ted Truman here at the Peterson Institute. So I have a question, I guess to some extent, bridges the two halves of this discussion. So on debt, right, so both Adair and Sean said capacity to repay the debt. So who says the debt has to be repaid? Why is that the test, right? I remember I was, you know, I’m wishy-washy. I studied under Tobin and he wrote on this great, what was it called? A committee on whatever it was called in the 1960s, right, and he said government debt plays a role, just like money does, right, and we don’t know what the optimal level of government debt or even private debt is and the notion that you have to repay it because in some sense that’s necessary before you appear before the pearly gates strikes me as nuts. Right?

So you can say that the level of servicing is a burden and therefore you should get the stock down, that I can understand, but the notion the test of repaying and actually you have to I think owe an extra step in order to do
that. And both Sean, who may have misspoken, and Adair who probably didn’t, talked to use the test of repaying the debt. Why?

Adam Posen: That is a very good note to end on. Sean, Adair and any others?

Sean Hagan: Yeah, I mean, back in the early 1980s the Fund came up with a series of papers at the beginning of the Latin American debt crisis and the premise of those papers, which I don’t think has changed, is that when countries can repay their debts, they should and that essentially the Fund’s policy should be supportive of that because the Fund’s role is to essentially promote, not only market economy, but medium-term sustainability and medium-term sustainability for most countries is returning to the market. And if you don’t repay your debt your capacity to return to the market is going to be more limited.

So we’re talking about the exception to that general rule and the question is what is the basis for that exception? And our view is that the basis for that exception should be capacity. Now we accept, just as it is in the corporate context, but we accept in the sovereign context, making judgments about capacity is a lot more complicated because of the fact that the assets are theoretically inexhaustible because of your taxing power, but you need to make a judgment as to what point that taxing power becomes counterproductive.

Adam Posen: Okay, Adair.

Adair Lord Turner: I think there is again, a crucial distinction, the one that I made between debt which is issued by somebody who is also a currency-issuing power and not. I think where you have debt issued by somebody who is not a currency-issuing power and cannot monetize it, of course there is no necessity to pay down the debt to zero. There’s nothing about the debts that need to be paid down to zero and I don’t think anybody ever runs those scenarios, but there is a need or there can be a need to have the debt at a sufficiently low level relative to GDP, that people believe that the debt servicing on that can be maintained and it will not relentlessly increase because if you don’t do that at some stage, the market will respond and say I don’t believe you’re going to repay me ever, therefore I’m going to charge you a high interest rate on your next bit of debt.

I think it is very different for a country which is a currency-issuing power and I used the reference to Japan and said this will eventually be permanently monetized. Of course, the alternative is that it just permanently rolled over. I mean, as long as the market is willing to accept that every year the Japanese debt-to-GDP ratio goes from 230 to 240 and then maybe in 50 years’ time it’s 500 to 560, well, why not? But what one’s dealing with there is a limit case where if people literally just accept
that as a pure token without expecting it to be repaid, debt has effectively become money and it’s just a financial asset created by the government and of course, there is also an interesting limit case there that the longer the maturity and the lower the interest rate, the closer debt is to money. I mean, money is just perpetual debt with a zero interest rate.

So I think there are some limit cases in there and the issue of debt sustainability for a country which is also a currency-issuing power is much less clear as a concept than for ones which are issuing not in their own currency, which also includes therefore now, the countries of the Eurozone.

Adam Posen:  

Thank you all very much. I think this has been a superb discussion and in particular, gratitude to Sean for engaging so substantively and frankly, but Anna, Ángel, Adair, all part of the A team, did a brilliant job.

We’re going to turn to private sector debt as Adair initially mentioned, and we all recognize the accumulation of private sector debt in some sense preceded and as the other side of the coin, too much of the recent public accumulation. And in particular, we’re going to have Susan Lund presenting the McKinsey Global Institute’s estimates on the stock, the current stock of private sector debt, household and corporate around the world. I think this is going to be a very equally important and rewarding discussion.

Just two last points, first, on Japan, I would urge as much as in theory Adair is right, that a zero interest government guaranteed thing looks like cash. You have to be a little careful when you start saying the market. The market in Japan that determines that there is an infinite appetite for that debt looks a little different in terms of its legal structure and who’s participating than the market for Greece and it’s not just as a cautionary note that we can’t all easily become Japan, nor would we want to.

Second, most importantly, I now have the pleasure to invite all our guests who are here, unfortunately not our guests on the internet, to join us for lunch. We will reconvene promptly at 12:30 with Susan Lund’s remarks. Thank you all very much.