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## SOVEREIGN DEBT

**Keynote address – Stanley Fischer**

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Thank you very much, Mr Chairman, and thanks to the Royal Institute of International Affairs and the World Bank for organising this event, which provides an opportunity for interaction among the many parts of the private sector and the several parts of the official sector on two major issues. One is Sovereign Debt – the declared title of this conference - and the other is the HIPC initiative.

I will touch only briefly on HIPC initiative, both because I expect Masood will talk about it at greater length and this is one of the topics on which there is no daylight showing between the World Bank and the IMF, and also because my IMF colleague Tony Boote will be talking about that tomorrow. Let me say only that on the HIPC initiative as it has been developed and finalised, at least in its current form during the annual meetings a few weeks ago, this is really a major initiative by the official sector to deal with a problem the depths of which became clearer and clearer as the 1990s wore on. Also the solution which has been developed is one in which the Bank and the Fund will be working very closely together under the guidance of a poverty reduction strategy paper, which is to be primarily the product of the highly-indebted country itself, and which is to be developed in co-ordination with civil society in that country, and the donors and the multi-laterals. The process of developing it should be an important part of the creation of a consensus on how to proceed.

It is also important that these poverty reduction strategy papers will be a coherent framework in which both the Bank and the Fund will be carrying out their operations, which is to say that the micro-economic and the macro-economic aspects of poverty reduction should be fully integrated and that in particular whatever the financial costs of poverty reduction are, as reflected in the strategy, they will be fully recognised in the macro-economic framework and, of course, there will also be an external dimension to that.

The intention is that these papers will include outcome-orientated indicators that will be monitored and against which progress will be measured. These papers will be published and we hope they will emphasise and make it much easier to ensure the accountability of those involved for attaining those goals following that framework and allowing outsiders to participate. It is a major initiative by the two institutions. It should double the amount of

debt relief for the highly indebted countries taking it to about \$50 billion for the expanded set of countries. It will require some work to be implemented. This is not something that has yet been done – work is getting underway now. We have had very good meetings between the Bank and Fund staff on how to proceed but we are not the main actors at this stage. The main actors will be in countries and it will take a very sustained effort by us but primarily by the countries and the civil society in the countries to make that work. We will certainly do everything that we can to make it work and we hope to get three-quarters of the relevant countries into the process by the end of next year.

I am also happy to add that agreement has been reached as you know on a funding package for the IMF's component of the financing of this which will involve both market gold sales, bi-lateral contributions and other contributions from our own resources that can be made available to deal with this. Given the time available, that is what I want to say on the HIPC initiative and we should have more discussion of that. It is not directly related to the sovereign debt subject of this conference but if you broaden sovereign debt to say the indebtedness of sovereigns then it is an aspect of what we are looking at in this conference and, in any case, it is on the agenda, it is important and it will be important to continue the dialogue on these issues in which many organisations taking part in this conference have been very influential – productively so.

Let me turn now to sovereign debt. We are looking at a market which, at the end of 1998 amounted to about \$560 billion – that is the amount of international debt outstanding at that point, of which about half had been issued by emerging market countries and about half of that in the form of Bradys. So this is a very significant source of funding for emerging market countries and it is a source of funding that began to develop after the debt crisis of the 1980's with the creation of Bradys giving a tremendous impetus for the developing countries. It is obviously a very cyclical source of funding – 1998 was not as good as 1997. It is one that could be developed much further but one of the things that we have to think about is just how much sovereign borrowing is a good idea for emerging market countries and it is entirely possible that the volumes that were beginning to flow in 1997, before the Asian crisis, were excessive rather than fully desirable.

One of the things that has become very clear as a result of the role of the official sector in this crisis, is that it is important to align the yields on these bonds with the risks that are faced by emerging markets in emerging market countries in the current international environment. It is quite clear that at some points in 1997 yields were too low - countries

were paying too low prices given the risks that they faced. It is very delicate topic. Obviously we would like to make life as easy as possible for emerging market countries. There is no intention of burdening them unnecessarily but it is also true that markets will not work well if prices do not accurately reflect risks.

The official community is struggling at the moment with the question of how to deal with aspects of bond financing that become very evident in prices, particularly the question of how to lengthen maturity, possibly restructure, or, in any case find a way of making it easier for countries to service this debt when they have to, or to agree on how to deal with the debt when debt servicing difficulties become very large and when the official sector is unable or unwilling, for good reasons, to provide the financing that would enable the servicing to continue.

We all know that in the 1980's it was argued it was relatively easy to deal with debt problems in the sense that there were few players - when countries got into trouble you could get them into a room and agree on how to roll over the debts. I think that the 1980's is seen through the hazy glow of memory. It was actually a very long drawn-out process and it was the so-called "lost decade" for Latin America - and it was a lost decade - except that it led to a lot of policy reforms that were important. We have to consider the following problem with regard to sovereign debt that even well-run countries, from time to time, get into trouble. The world environment turns bad, political circumstances change in a country, governments change, policies which look good in one scenario look bad in another - all those things happen and, from time to time, a country will have trouble servicing its debt, it will get into a crisis of some sort.

We in the official sector do not want to be in a position of always having to find the financing that would make it possible for countries to continue to service their debts uninterrupted for two reasons. If that was the official doctrine, the amounts of financing we would have to provide would keep rising - the world hazard issue is a very real one and we would not have that amount of money - and secondly public opinion will not support that. It is not politically feasible and it is not economically feasible and we have to accept that at some point the official sector will not be able to bail out countries that get into difficulty. We have seen that in the most important case in the last few years, possibly in this decade, which is Russia. The Russian default, unfortunate as it was, is an important illustration of the fact that private sector financing may at some point become impossible to finance and that the

official sector may not be able or willing to continue to enable the country involved to deal with that.

We do not want to encourage that sort of behaviour. It is certainly not conducive to the good functioning of the financial markets. So, the most important thing that anybody could do is try to prevent the emergence of situations in which countries are unable to service their debts and that means an emphasis on prevention - something that is being done by the official sector in a very major way - is among the lessons drawn from the Asian crisis. In supporting good macro-economic policies in particular, we are working hard to strengthen financial systems in consideration of the exchange rate system that countries should adopt with a clear understanding a lesson, which we have known for 30 years, that you cannot have freely mobile capital, a fixed-exchange rate, and a monetary policy directed at domestic objectives. That triad is incompatible. We have known that for 30 years, we understand it far more vividly as a result of the recent crisis than we did before and therefore you have to accept the consequences by removing one of those premises, and the one premise to remove is the fixed exchange rate and go to floating.

The other is to remove the premise that domestic monetary policy is directed at domestic objectives and say the monetary policy's only goal is to maintain the exchange rate and then you get into very hard pegs. Well, we have learnt that lesson and that would reduce the frequency of crises.

We also need to worry about the structure of debt of emerging market countries and there is a lot of work going on that by the official sector. However, it is surely also an important obligation of the private sector as it purchases and prices debt to worry about the liability structure of the countries with which it is dealing. We have also been encouraging countries to try to line up contingency financing from the private sector as Argentina, South Africa and Mexico have. The experience with that is mixed and we have, in the IMF, created the contingent credit lines which have not yet been drawn on - we have made no CCL loans - but some countries have expressed an interest and we are continuing to talk to a number of countries about the possibility of having a CCL.

One can take all the preventative measures one wants and we need to do all those things, and we are doing them. When people say the architecture of the international system is not being changed - there is the Paul Walker statement "You're not talking about architecture, you're talking about interior decorating" - that may be true. It is true in the

sense that we are not tearing the house down but a lot is going on in areas like the creation of standards and in work on macro-economic policies and on helping countries restructure their debt. That is all happening but it will not in the end prevent the eventual occurrence of occasional crisis, and having a floating exchange rate is not 100% guarantee against a crisis because countries can still get into trouble by having too large a debt that they cannot service in certain circumstances. So we are going to have to deal, despite what we hope very much will be a much smaller mobility of prices, with crises and when that happens the question is how to involve the private sector. It is an issue on which we have been talking with the private sector a great deal, talking to each other a great deal. The CCL (contingent credit line) is one way of involving the private sector.

We are also concerned with the possibilities of changing the structure of debt, for instance by including collective action clauses in bonds; by developing structured debt – that is debt in which the payoffs will be more related to the possibility of the country to pay i.e. related to GDP growth rather than absolutely fixed.

It is interesting that we now have the opposite of structured debt that enables countries to make its payoffs. We have put options in bonds in many countries that enable the holders of medium and long-term debt to put a claim to the country when it gets into trouble – precisely the opposite of something that would help countries deal with crises.

All that can be there. There is tremendous resistance to the inclusion of collective action clauses for reasons that are difficult to understand. It is simply not realistic to believe that countries will not at some point have to restructure their debts or have to find a way of deferring things for a while. Removing uncertainty about how that will be done must be a plus, and some of the people we have spoken to in the private sector say putting in explicit clauses about how to deal with a country's difficulties will in fact reduce the spreads because what we have now is a great deal of uncertainty about what will happen, and it will let us get this thing cleared up, let us dispose of the uncertainty and we will find yields going down. The other side is nobody quite believes that - nobody has made the experiment yet. It will happen at some point and we will be able to see whether any of it works.

Absent those clauses – I see Willem Buiter is going to talk about UDROP tomorrow which is an even more pervasive form of single action clause because the country will have the right to do that at a price – we will from time to time find it necessary to deal on an ad hoc basis with a country's problems and we are seeing two cases of that now. One is Russia,

and Miss Kurzianov will be talking to you about its interactions with its creditors, and the other is the Ecuadorian case.

Many will ask why Ecuador defaulted? The answer was that Ecuador's financing needs, relative to the ability of the public sector to provide resources or relative to the country's means, were simply too large for it to continue servicing the debt. It decided on its own that it should seek to restructure the debt. Due to the fact that the legal framework is not really there it is proceeding on an ad hoc basis - it is meeting with its creditors. There is a legal threat hanging in the background but discussions so far seem to have been reasonably constructive. It could be a long process - these are not simple matters and they are much less simple when you are dealing with bond holders than when you are dealing with a limited set of banks. This could happen from time to time. It is not something that you want to happen but the possibility of it happening must be recognised.

Co-ordinated action by creditors happened in the Korean case - that was of course much easier because there were banks involved. We do not know what the ultimate framework will be. We are in a process of developing a case law for these cases and Ecuador and a few other countries are among the first to have to deal with this - no problem. I expect that lessons will be drawn from these experiences and that as we go forward we will have a better idea of how to deal with this important weakness in the market for sovereign debt.

This is potentially a very important market. Of course, those who buy this debt are attracted by it because they have believed that in some sense it enjoyed both superiority, it had a halo around it and that the official sector might, possibly would, regard it as its obligation to enable this debt to be serviced in all circumstances. That will not be true; it is not true - independent of what countries are able to do - and we are now, together, in the search for a way of resolving that issue. It is not the easiest of processes but it is very important for the efficient operation of what can be an increasingly important market for developing countries that we ensure both public and private sector that the risks that are present in these markets are reflected in the pricing structure of the relevant assets. That is the process we are engaged in now in a number of countries - private sector and public sector jointly - and the effective outcome of which will determine to an important extent the role that the private sector can play in financing emerging markets and emerging market countries and helping ensure a recovery of sustained growth for these countries.

Thank you very much.

