THE IMF AND SOVEREIGN DEBT

Remarks at the Conference organized by the Bank of Canada
in honor of John Murray (August 24, 2014)[1]

Jean-Pierre Landau

Introduction

- The IMF has a great expertise and long experience in dealing with sovereign debt.
- The IMF knows how to deal with debt held by public (official) creditors: most IMF programs in the 70s to 90s were underpinned by (and closely articulated with) Paris Club rescheduling..
- The IMF also developed a great expertise in coping with private bank debt. In the 80s, Latin American debt was dealt with efficiently and energetically under IMF's leadership. More recently, during the global financial crisis, the IMF sponsored a "Vienna Initiative" to coordinate the stabilization of outstanding bank debt in Central and Eastern Europe.
- The IMF had a lot of practical knowledge and, at that time, there was no need for a doctrine since debt was mostly held by banks:
    - Collective action problems could be solved by arm-twisting the banks into accepting debt rescheduling.
    - Amounts of "new money" needed were small by today's standards and, above all, commensurate with Fund's resources (which could be used to "catalyze" private contributions)
    - Restoration of market access was not a main objective of Funds' programs as the focus was on current account and it was assumed that debt rescheduling would buy sufficient time for adjustment
- Overall the Fund had both the resources and the power to play its "catalytic role" i.e. use its own money to mobilize a maximum of external (private and official) resources. In modern parlance, we would say the Fund could easily "leverage" its contribution.

[1] this draft : June 2015

I/ - New challenges in the 21 st century

a/- Starting in the mid 90s and going into the 21st century, the IMF was confronted with new challenges in a transformed environment:

- Emerging Economies' sovereigns started issuing bond debt in significant amount (as compared to bank debt) . Collective action problems are much more difficult to solve with bond debt: sovereign bond debt is constantly traded between a multiplicity of creditors, with the possibility that (1) all private creditors will try and free ride on official support and (2) that some of them will take advantage of concessions granted by others[2].

- A first, and ambitious, attempt was made with the proposal for a SDRM (a Sovereign Debt Resolution Mechanism) where the Fund would have been granted legal and operational powers to "resolve" Sovereigns i.e. implement a compulsory debt reduction scheme when needed. That proposal was finally rejected by the membership.

- Collective action clauses (CACs) were progressively introduced in all (including advanced countries') sovereign debt issuances: those clauses allow for a qualified majority of bondholders to agree on restructuring scheme that would therefore be binding for all other creditors. They were extensively used in the Greek program. However they have recently been fragilized by US courts decisions on Argentina through a very strict interpretation of the "pari passu" clause that would, if confirmed, in effect prevent the use of CACs.

b/ - Capital flows become dominant in balance of payment (as compared to current accounts)

- As early as 1994, with the Mexican crisis, it became clear that capital flows (not the current account) were the main drivers behind balance of payment crises. This trend was confirmed and amplified with the Asian crisis (1997-98), the euro crisis (2010-11) and, more recently with the turmoil affecting emerging economies in June 2013. Important consequences follow for the design and implementation of IMF's programs with regards to sovereign debt.

- As capital flows dwarf the current account by an order of magnitude, there is a change of scale in external resources needed from all contributors including the IMF : bigger Fund resources are needed to prevent self-fulfilling crises or "buy time" for the adjustment process . Catalytic role becomes more difficult .

---

[2] 2 The same problems arose for bank debt with the development of sovereign Credit Default Swaps (CDS). Those instruments allowed for the trading and dispersion of credit risk and , in some cases, may have created incentives for creditors to push for default (and be fully compensated) rather than accept rescheduling or reduction.

This led to the 2002 decision on "exceptional access" where the Fund was allowed to go far beyond previous limits in providing support to program countries

- As countries became increasingly integrated to (and sometimes dependent of) global capital markets, restoration on market access became a primary objective of Funds' programs , and a major benchmark to judge their efficiency. In turn, restoration of market access required that debt be judged sustainable. So, the decision on "exceptional access" was accompanied by the requirement that the Fund would subordinate its intervention Criteria on "high probability" of debt sustainability to "debt sustainability assessment" and ask for debt reduction if the assessment showed its necessity

- Finally, capital markets create new channels of financial contagion between countries. This became a concern when dealing with sovereign debt as it was feared that debt reduction in one country would trigger broader systemic consequences for other economies.

II/ - Designing programs

The art and science of program design rest upon finding the right equilibrium between "adjustment" (the reduction of domestic demand) and "financing" (the provision of external loans and debt concessions). Defining the proper balance has become extremely challenging when debt sustainability becomes a major concern. The reason is that, in most cases, there is no clear-cut answer to the question : "is debt sustainable". In truth, debt may be sustainable in some states of the world (strong growth, low interest rates) and unsustainable in others. This uncertainty creates a fundamental indeterminacy as, in turn, growth and interest rates depend on whether debt is judged sustainable. So, program designers face the following circularity:

- growth depends on restoring financial market access;

- market access depends on debt sustainability;

- and debt sustainability depends on growth (as it is judged mainly through the debt/GDP ratio).

This circularity generates possible feedback loops and multiple equilibriums. Overall, the success of IMF's programs has become heavily dependent on "confidence effects": if markets believe that the debt/GDP ratio will be stabilized, they will provide the necessary funding, thereby allowing growth to resume and their belief will be self fulfilled. In the reverse case, the country will be caught into a downward spiral of low growth and increasing debt/GDP ratio.

III/ - the Greek crisis

All the challenges and difficulties the Fund was facing in dealing with the new environment came into the open with the Greek debt crisis.

In terms of magnitude and scale: the Greek program was the biggest ever implemented by the Fund (as measured by the access in % of quota). Greece was a stress test for the "exceptional access" framework and it failed

In terms of uncertainty surrounding the program: it became clear very early in the implementation that most assumptions about growth and debt sustainability were overly optimistic and that targets would be missed by significant margins.

One reason was that the Fund accepted to circumvent its own requirement of "debt sustainability". Taking into account the special circumstance that Greece was part of a monetary union, the IMF introduced a "systemic exemption" (a code word for the risk of contagion inside the euro area) that basically waived any condition related to debt. Thus, as requested by European authorities, the first Greek program did not comprise any debt reduction. This exemption was hard to accept by the Board and the membership and there is evidence that it created great resentment and a lot of skepticism inside the Fund.

This skepticism was very apparent immediately after the program was approved and quickly undermined any potential confidence effect. In a few weeks, Greece settled in a "bad equilibrium", with capital outflows, growth dropping, debt scenarios loosing any credibility and constant revisions in the program and debt sustainability assessments.

Finally, Greek private creditors had to accept the biggest debt reduction ever (in total amount) and official support (through bilateral loans) reached a all time high level.

The travails of the Greek program triggered a lot of soul searching inside the IMF, that led to the recent initiative and proposal of a new framework

IV / - The possible new framework and "reprofiling"

In June 2014, the IMF staff circulated a paper outlining a possible new approach for dealing with sovereign debt. The main innovation is the possibility, for the Fund, to ask for a "reprofiling" (in effect a rescheduling) of sovereign debt as a condition to giving or maintaining its support to a program country. Such a "reprofiling" could take place anytime (either at the initial stage of a program or in subsequent revisions) and involve either moderate or strong concessions by creditors (in terms of net present value). Most importantly, the "systemic exemption" introduced with the Greek program would be eliminated.

Many details remain to be discussed and approved about this new approach. Some advantages are already apparent:

- With the possibility of "reprofiling", the Fund gives itself much needed flexibility in dealing with excessive debt situations. In effect, the approach acknowledges the intrinsic uncertainty attached to debt servicing and the impossibility, in most cases, to decide ex ante if the debt is sustainable or not; and, in the later case, which is the level of reduction (and effort by creditors) that may prove necessary.

- With this new flexibility, the Fund is strengthening its hand. It avoids being cornered into either forcing a traumatic debt reduction or accepting to finance an unsustainable program. If collective actions issues can be resolved, the new approach would provide the Fund with new leverage and allow it to its play catalytic role in mobilizing efforts by all bondholders (as well as official creditors). In a favorable scenario, the Fund could de facto find itself with powers and tools equivalent to those it would have got with the SDRM.

Implications could be broader. Up to now, since the failure of the SDRM, there has been no agreed ex ante framework for dealing with sovereign debt. Problems have been addressed on an ad hoc basis. For many analysts, such "constructive ambiguity" is the only realistic method. Others would argue in favor of a more formal framework that would define ex ante how debt would be treated according to different legal and economic criteria.

The IMF approach could go both ways. It could be the beginning or the end of constructive ambiguity. It could lead either to more discretion in dealing with debt overhangs or, on the contrary, usher a new era where default would be considered as an ordinary feature of global capital market rather than an anomaly to be avoided.

Behind those apparently technical modifications may lie a fundamental question and potential change: will the new framework "normalize " sovereign default, as the SDRM would have done ? Will Indirectly address the ex ante problem: explicit recognition of possible rescheduling may lead to better internalize and prize the default risk

V/ - a question for the future: should the possibility of default be an explicit part of any debt resolution framework: the "moral hazard" vs "financial stability" view.

For the future, the Fund is confronted with two big issues:

- ex ante: building the appropriate framework to create market discipline avoid moral hazard and over borrowing

- ex post: building a robust mechanism for crisis management

Obviously, both are linked: a predictable and credible crisis resolution framework would create good (ex ante) incentives and avoid moral hazard. However, there are many possible ways to confront those two challenges. To simplify, one may think of two opposite approaches: one emphasizing the need to avoid moral hazard; the other giving a higher priority to preserving financial stability in all circumstances.

1/ - the "moral hazard view "

It looks favorably to the possibility of sovereign default. Indeed, it sees default as an integral part of a good framework for crisis resolution, " a natural feature of the market mechanism, not something to be avoided at all costs". The possibility of default would make market participants constantly aware of credit risk and reduce, if not eliminate, moral hazard.

Overall, the possibility of default would :

- limit the need for official financing
- lead to a better pricing of risk and reduce over borrowing
- align the incentives of debtors and creditors to seek debt relief early
- provide clarity and predictability in resolution process

2/ - the " financial stability view "

It seeks, in priority, to protect the financial system from the volatility and uncertainty that could be created by the permanent possibility of sovereign default.

One big difference with previous period is that, as a consequence of the global financial crisis, public debt is mainly located in advanced economies (with average ratio of 80% GDP vs 30% for EMEs). This is a total reversal from the situation that prevailed 15 years ago

That debt is being used as a "safe asset" for Forex reserves, precautionary motives and collateral purposes. There are concerns about a shortage of those assets for the future. There will likely be a strong demand for this debt. The financial stability view states that it would be dangerous to make sovereign debt "information sensitive" by introducing ex ante the possibility of default. Possible consequences would be the multiplication of self fulfilling liquidity crises, permanent uncertainty on the roll over of short term debt, and, more generally, a generalization of "multiple equilibriums" situations on debt markets.

If debt sovereign debt becomes more information sensitive, consequences for monetary policy and Central Banks would be mixed:

- on the one hand, the possibility of default makes it less likely that Central Banks will resort to inflation to reduce the real value of debt : monetary policy would be more credible

- on the other hand, there may be a need for more frequent interventions by Central banks as liquidity providers to deal with roll over crises

The net effect on Central banks' credibility, moral hazard and financial stability is uncertain. There is need to think very hard before we move to a regime where sovereign default is considered as normal and commonplace.