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Concluding Remarks by the Acting Chairman
International Debt Adjustment - Recent Proposals
Executive Board Seminar 96/2
February 16, 1996

Executive Directors welcomed the opportunity to hold an informal discussion on certain aspects of handling financial market crises involving sovereign debtors. The discussion complemented, to some extent, their earlier discussion on the note on an international debt adjustment mechanism for sovereign debtors.

Directors agreed that the growing integration of capital markets on a global scale had changed the environment in which countries conduct macroeconomic policies. The new environment, while easing countries' financing constraints and creating opportunities for the more productive use of world savings, carried the risk that loss of market confidence could cause massive reversals in capital movements and destabilizing shifts in asset prices. Directors therefore stressed that, while all countries needed to direct their policies toward the objective of growth with price stability, they also needed to ensure the credibility of their policies. They reiterated their support for more timely and effective surveillance of exchange rate policies and capital movements by the Fund and actions, such as the data dissemination initiative, designed to strengthen the basis for timely and well-informed decision making by market participants.

Directors agreed that, in the event of a financial crisis, the key element in its resolution was the prompt adoption of a comprehensive package of adjustment measures by the country or countries affected. External support, however, was also likely to play a vital role both in supporting this adjustment and in restoring market confidence. While experience of recent crises had shown that the amount of financial support that might be needed could be significantly greater than in the past, many Directors emphasized that market participants should not assume that official financing would or could be made available in the event of a crisis on a scale that would ensure that all of a country's creditors could be paid on schedule.

Directors agreed that the handling of some financial crises might require that the country or countries be given the breathing space needed for adjustment policies to work. This might involve the restructuring of payment schedules more in line with the country's payments capacity. While existing mechanisms for handling official bilateral claims--the Paris Club--and medium- and long-term commercial bank claims--the London Club--had worked well, many Directors were less confident that forbearance on the part of the holders of securitized claims could be achieved. Most Directors believed that, in some circumstances, countries might be obliged to impose a moratorium on certain debt-service payments while seeking to reschedule their obligations, and that careful consideration should be given to improving existing mechanisms.

Directors noted that it was difficult to give general rules on the scope for a suspension of payments. The coverage would need to be such as to give adequate breathing space to the country, while not precipitating a loss of confidence by other creditors whose financing was vital to the country's recovery. The distinction between resident and nonresident creditors in a world of open and integrated capital markets was seen to have largely lost its relevance. Several Directors argued that the key distinction, on the basis of which a moratorium might be restricted, lay in the currency denomination of the debt. However, most, but not all, Directors cautioned against the use of exchange controls as an instrument for handling crises, arguing that payments suspensions should apply equally to domestic and nonresident holders of those forms of debt on which payments were being suspended. Directors generally agreed that a moratorium on the service of a government's domestic debt would not be helpful.

Most Directors considered that, if a suspension of payments on certain debt-service obligations was an essential element in resolving a crisis, it should be supported by the international official community. While many Directors considered that the possible rush of creditors for the exits and the problems of collective action constituted potential market failures that could justify official intervention in this area, others considered that these phenomena were an essential feature of the market process and should be allowed to take their course.

Lending by the Fund--and the release of catalyzed financing from others--to a country with a unilateral moratorium on certain debt payments would be a concrete form of support to such a debtor. A number of Directors, noting that the Fund had, in fact, already been lending into arrears, asked the staff to consider further the issues related to the circumstances in which Fund lending into arrears might be acceptable. Other Directors noted, in this respect, that care would be needed to maintain the Fund's neutrality as between debtors and creditors and to avoid moral hazards.

Most Directors were of the view that a country following strong corrective adjustment policies should be able reach agreements with its creditors on a necessary restructuring of its obligations within a reasonable period. Some Directors considered that there might be merit in proposals to facilitate the renegotiation of securitized debt, such as the creation of bondholders' committees or the inclusion of clauses in bond contracts allowing a qualified majority of creditors to change the terms. Most speakers, however, believed that it was up to bondholders to organize themselves.

Directors were cautious--and most were negative--about proposals for establishing a formal international debt adjustment mechanism. They were concerned that, if such a mechanism were seen as making it easier for troubled debtors to restructure their debts, international capital markets might raise the cost of capital to a broad range of developing country borrowers. Proposals in this area would thus have to balance the need for speedy resolution of individual crises with that of protecting the rights of creditors to receive what is due to them. Several Directors asked the staff

to continue to keep proposals in this area under review. Directors recognized that large-scale financial assistance to troubled debtors, or mechanisms to give relief on debt obligations, had the potential to create moral hazards for debtors. They considered that tight conditionality in the provision of assistance was the best safeguard against such moral hazards. However, they were also concerned about the moral hazard that applies to creditors and generally wanted to maintain constructive ambiguity as to the amounts and speed with which assistance would be available to minimize this particular hazard.

Finally, we are in the process of clarifying very complex matters. We should continue that process, realizing, though, that we are on slippery ground and that it remains quite unclear where we will come out.