Discours de M. Jacques de Larosière prononcé le 17 octobre 2002

"Can we break the crisis cycle for emerging markets ?"

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The crucial objective we are facing is to restore an environment that will stimulate private capital flows towards emerging markets.

Indeed, the latest statistics from the IIF show that there has been a dramatic fall in private capital flows to emerging market economies over the recent years. From 2000 to 2002, total net private flows have fallen from 187 billion dollars to 123 billion, i.e. a 34 % decline. Portfolio flows in net terms amounted only to some 10 billion dollars in 2002 against some 20 billion in 1999. As a share of emerging markets, GDP, net private capital flows have declined from 4 % in 1992 to just over 2 % in 2002.

This is a dangerous situation that is severely impacting growth rates for a large number of emerging countries especially in Latin America.

How should we cope with those problems ?

I will focus on three aspects :

- basic policy conditions need to be ensured in order to foster market confidence;
- everything must be done to encourage the private sector to finance emerging countries economies;
- if crises occur, they should be dealt with by negotiations between the interested parties in a market friendly way ; what should be the role of collective action clauses in this regard ?

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I. Basic policy conditions are needed to restore confidence :

1) **Emerging market countries** must, of course, follow appropriate macroeconomic policies geared to low inflation and to fiscal discipline, and pursue structural reforms leading to a more efficient functioning of domestic markets.

   Confidence requires also transparency and good communication with market participants. Significant achievements have been realized over the past years in this field. I will not therefore insist on this aspect of the issue.

2) The **IMF** has a crucial role to play as agent of adjustment.

This is indeed the central vocation of the Fund, the one that no other institution, let alone the markets, can take on.

The Fund has an essential role to play at the prevention stage and also in dealing with country problems as they arise.

I shall not get into the details here. Let me just stress that the role and responsibility of the IMF in contributing to the adjustment process is key to the central issue which is the title of this conference i.e. "Breaking the crises circle for emerging markets ?". I insist on this because it is sometimes the view (or the fear) of many observers and actors that the Fund is mainly the financier of the system. I could not disagree more with that view.

3) The **markets** must, as far as they are concerned, bear the consequences of their decisions. There is no way some public institution could "bail them out". Private risks must be assessed and priced by those who take them and, in the event, entail losses when things go wrong. This is, in fact, what has happened in many cases (like Russia or Argentina)

   But, in order to perform their functions (direct investment, credit intermediation, acquisition of fixed income or other instruments, …), the markets should know :

- what are the exact figures and data relative to borrowing countries (this goes back to the above mentioned issue of transparency) ;
- what are the views of the IMF, when problems arise, about future balance of payment viability ;
- what are the basic "rules of the game" in terms of the IMF's use of its own ressources.

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II. Encouraging the private sector to finance emerging markets economies :

Given the present state of the world economy, and the worrisome fragility of financial markets, it is extremely important **not** to make any mistake and, on the contrary, to do all that is possible to encourage confidence and trust.

Let me stress, in this respect, three views :

1) It is essential to do all that we can **to restore a culture of contractual observance and respect**. This has been too often overlooked over the past years by too many official circles. Without the fundamental notion that a contract must be honored and will be honored (barring absolutely exceptional and "force majeure" circumstances), it will be very difficult to get private flows back on course. I have always considered that the scrupulous observance of contracts (or of the terms of properly negotiated amendments and restructurings of contracts) should, in particular, be at the heart of IMF programs and conditionality.

2) In this respect, I believe it would be most unwise for the international community to build legal systems that are based on the assumption of failure and default.

I cannot understand the emphasis and focus that are being presently put on the project of building a statutory mechanism to deal with sovereign debt defaults (SDRM). Not only such a system is not needed, but it can have (I am afraid it is already having) negative consequences on market appetite towards emerging economies.

a) Firstly, **such a system is not needed**. Debt problems of sovereigns have most generally been resolved in the past through negotiations. What you need is to get the creditors and the debtors together and to have them negotiate in good faith in order to achieve reasonable solutions that take into account the legitimate interests of both parties.

This process, which goes back to the XIXth century, has been enormously facilitated by the existence of IMF programs which can provide the "intellectual underpinning" without which it is difficult to evaluate the chances and the constraints of a country's return to balance of payments viability and economic growth. That is indeed the crucial role of the IMF. The world does not need legal technicalities for (hopefully exceptional) cases of default but the ability to negotiate, in the most straightforward and informed way, debt restructurings when they are needed

One sometimes objects to this view that the existence of a dispersed population of bondholders (instead of a relatively limited group of banks) makes these ad hoc negotiations almost impossible. The history of the XIXth and XXth shows that this objection is not verified by experience. There are innumerable examples of successful negotiations including bond holders over the last years. Actually, no cases where restructurings were needed have been blocked by investors unwillingness to negotiate or by legal actions. I could add that in the case of Argentina, a bond holders association (A.B.C.) spontaneously organized itself, well ahead of the meltdown. That association - which represents a significant share of bond exposure- proposed to the Argentine Government and to the multilateral authorities to start a debt renegotiation including inevitable haircuts. Unfortunately, the political conditions in Argentina in the second part of 2001 did not allow this process to be carried out.

One could add that the legal system proposed under the SDRM, had it existed at that time, would not have allowed to resolve the debt situation Argentina, because two major conditions were lacking : the political will on the side of the government and the beginning of an understanding of what could be an IMF program and its financing requirements.

Furthermore, the SDRM applies only to the debt of sovereigns issued under external juridictions. But we all know that much of sovereign debt issued by major emerging countries is under domestic law and therefore would not be covered by the SDRM. Neither would be covered the very sizable external debt incurred by the private sector in many of these countries.

Lastly, the fear that "free riders" and litigation actions might derail a debt restructuring cannot, in my view, justify the establishment of a statutory solution : never, in the past, such actions have prevented a debt negotiation from taking place.

b) **Not only the SDRM is not needed but it can be the source of serious problems**.

It is a fact that neither sovereign issuers nor the private markets are favorable to this mechanism. Issuers are of the view that such a statutory system could instill in the minds of operators the idea that default is now becoming a central assumption carrying a high probability since the G7 and the IMF are putting such pressure and political clout to establish the mechanism. This is bound to have a cost in terms of market appetite and therefore lead to higher spreads as well as lower flows. So, we should ask the question : is it wise to allow such negative reactions to happen especially under present circumstances ? My answer is definitely negative. Markets are apprehensive, some countries are already closed off : no chance should be taken that could tilt things further in the wrong direction.

Given the fact that sovereign debt is basically held by private parties, and that both sovereign issuers and private holders hold such a unanimous view on this matter, one should really think twice, or thrice, before moving in the direction of a statutory bankruptcy system.

It is inconceivable that in today's world, a mechanism involving issuers and private investors could be advanced without the support of both parties.

III. Can collective action clauses help, in a market friendly way, to facilitate negotiations when a crisis occurs ?

As I said earlier, when a crisis occurs and debt repayments on schedule are no more possible, reality forces market participants to discount the value of their claims and to enter into debt negotiations. In this respect can the introduction of collective action clauses (CACs) in bond contracts (and possibly some others) help the process of an orderly negotiation ?

The G10 and the G7 have been supportive of this idea. Under the auspices of the IIF and five other private associations representing bondholders, an enormous amount of work has been done and actually was being refined when the public endorsement of the SDRM by the international monetary committee in Washington took place a couple of weeks ago.

We will see what consequences this endorsement is going to have on the private sector discussions on CACs.

Of course, CACs (like any other legal solution) are not going to change the world and create miracles. But, at the margin, such clauses might help, if they include appropriate supermajorities. I believe the outcome of the work on this project will be heavily dependant on the attitude of issuers and of the private sector. This is why it is so important to listen to their representatives today in this most timely and topical conference.

I should add that one of the major objections often addressed to CACs vs SDRM is that it does not deal with the stock issue. But some proposals (see the JP Morgan's suggestion) could facilitate the solution of this problem.

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In conclusion, let us remind ourselves that the responsibility of public and private institutions is to allocate as efficiently as possible their scarce resources and to create the best environment in terms of trust and market confidence. If a regulatory project is susceptible of carrying a risk of "drying up further the external sovereign debt market"[1] as recently observed by Mr. Ed Truman, then one should abstain, or at least put the matter on the back burner.

The last thing we want is to risk deteriorating -for some legal purposes- the whole emerging market asset class of debt instruments.

A more fruitful avenue might be, as some officials have recently suggested, to have all players agree on a "code of good conduct" whereby the role of each party (issuers, private creditors, public creditors, multilaterals) in reaching collaborative solutions to a debt crisis would be laid out.

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[1] "Threats to private sector will not solve debt crises", letter from Edwin Truman, Financial Times, October 7, 2002.