The views expressed in this presentation are those of the author only, and does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the presentation.

Keynote Speech
by
Mrs Teresa Ter-Minassian
Director of the IMF Fiscal Affairs Department

International Conference on Fiscal Risks
Paris, October 28, 2008

This Conference comes at challenging times. As you well know, we have been experiencing the largest international financial crisis since the Great Depression. And its consequences on the public finances are still being assessed and are likely to reverberate for a long time. This Conference provides a good opportunity for us to share experiences on fiscal risk disclosure and management. Right now, the focus of many policymakers is on issues related to recapitalization and other forms of public support to private banks, and the use of partial or blanket guarantees to financial sector activities, which will require careful quantification and monitoring of the attendant fiscal risks. But the conference will address the broader issue of how to be best prepared in the future for all fiscal risks—not only those arising from the financial sector.

I am confident that this Conference, by bringing together public sector officials from such a wide range of countries in Europe, can be a catalyst for new initiatives on dealing with contingent liabilities.

As a background to the discussion, let me share with you some views on the global economy. I will then turn to the subject matter of this Conference, highlighting the importance of accurately identifying, disclosing and managing fiscal risks.

Financial Crisis

As I mentioned before, we are living through the most challenging financial crisis since the Great Depression. The world economy is slowing rapidly, dragged down by problems in the financial sector and slumping housing markets in a number of advanced economies. Further deleveraging, as financial institutions continue to suffer losses, is weighing on credit and activity in advanced countries. Some emerging market and developing economies are already experiencing tighter financing conditions, while past increases in food and fuel prices continue to feed through to inflation.

Against this background, policy makers are assessing their scope to support growth through macro and micro policy tools The most obvious use for fiscal policy is to ease pressures where they are greatest: in the financial and housing sectors. But countries that enjoy relatively low debt can also undertake a broader fiscal stimulus. There is also scope to use monetary policy to support growth, building on the collaborative easing that we have seen in recent weeks.

Economies have differing degrees of freedom to act. Some can afford to draw reserves down to finance a temporary and sudden shortfall in capital flows. But others will need to raise interest rates to stem outflows and bolster confidence in their currencies. Some may even have to tighten the fiscal stance in the face of more binding financing constraints.

Some countries may need help, and possibly very substantial help. At the last IMF-World Bank Annual Meetings earlier this month, the IMFC called on the Fund to offer financial support to members that need it, and we will heed that call. In fact, we have activated emergency procedures to respond quickly to urgent requests, with high access financial programs, based on streamlined conditionality that focuses on crisis response priorities. Negotiations have already been concluded with two countries (Iceland and Ukraine) and others are close to conclusion.

Let me now turn to fiscal risks.

Sources of Fiscal Risks

In a broad sense, fiscal risks can be defined as the possibility that fiscal outcomes deviate from what was expected at the time of the budget or other forecast. This definition implies that sources of fiscal risk can be quite varied. These include various shocks to macroeconomic variables, such as growth, commodity prices, and interest and exchange rates, calls on explicit liabilities defined by law or contract, or calls on implicit liabilities based on moral or expected obligations for the government, as seen in recent bailouts of banks.

Understanding the specific source and nature of fiscal risks is essential to identify the required government policy response. A policymaker would find it useful to have tentative answers to the following three main questions:

First, are shocks temporary or permanent? For example, higher-than-expected fiscal deficits resulting from temporary economic slowdowns may simply require allowing the automatic stabilizers to work. Permanent shocks affecting fiscal sustainability in a more lasting manner would have more wide-ranging implications.

Second, are shocks correlated? Shocks that are likely to offset each other would require little response, whereas the possibility of positively correlated or mutually reinforcing shocks, such as a banking crisis accompanied by a sharp fall in the exchange rate, would warrant decisive policy action.

Third, can shocks be quantified or disclosed? Quantification is usually much easier for macroeconomic risks and explicit liabilities, which include contractual terms and amounts. Implicit guarantees, on the other hand, are always difficult to quantify ex-ante, especially since the probability of the event occurring is always difficult to estimate. In addition, expectations of government action need to be managed carefully to avoid moral hazard issues.

Identification of fiscal risks

Of course, country authorities must identify the main sources of fiscal risk before being able to disclose or manage such risks. Although I am sure that new lessons will emerge from the upcoming discussions during this conference, I would like to mention some issues that I see as essential for policy makers to assess fiscal risks as comprehensively as possible:

- The overriding objective in identifying fiscal risks is to assemble a list of all significant ones to which the government is exposed, together with an indication of their relative importance; whenever possible, risks should be quantified in terms of amounts (point estimate and range) and probability of occurrence. While this exercise may already be undertaken by many finance ministries on an ad-hoc basis, a more formal approach would help ensure that all relevant information is available when needed.

- In addition, each government unit should communicate to the risk- monitoring agency (typically within the ministry of finance) all information it has on sources of fiscal risks; in particular, entities that issue government liability instruments (including contingent ones) should maintain, and communicate to the risk monitoring agency, a register with details of all the instruments.

- To reduce exposure to risks arising from non-financial public enterprises, public financial institutions, and sub-national governments, the ministry of finance should routinely monitor and report on the fiscal performance and financial position of these entities; the extent of monitoring, of course, should be commensurate to the degree of fiscal risk those entities pose to the budget.

- Finally, an important issue in the identification of fiscal risks is how to maintain an effective channel of information-sharing with the supervisors of financial institutions. Country practices differ in this regard, and this may be a useful area to compare notes during this Conference.

Disclosure of Fiscal Risks

Authorities' commitment to making information on fiscal risks publicly available—by subjecting the analysis to additional scrutiny—helps ensure that risks are fully recognized and properly assessed. Moreover, disclosure may help to manage risks, and reduce borrowing costs in the longer run. Transparency also strengthens accountability for effective risk management; improves the quality of decisions on whether the government should take on risk in the first place; and promotes earlier and smoother policy responses.

Let me highlight that the emphasis here should be on a comprehensive disclosure of fiscal risks, with exceptions based on clearly defined criteria, relating mainly to the possibility that disclosure might engender moral hazard or harm the national interest. For example, reporting on implicit liabilities from the banking system prior to an actual crisis would be inappropriate because it would be perceived as an unconditional guarantee of assistance, thus leading to

undue risk-taking by the private sector. Similarly, it might be detrimental to disclose information that would harm the government's position in litigation or negotiations.

We look forward to hearing from ministry of finance officials on their fiscal risk disclosure practices. When IMF staff reviewed country experiences last year, it found that some countries already report fiscal risks in their budget-related documents and annual financial statements. But one practice that I find particularly useful is the consolidation of information on fiscal risks in a single "statement of fiscal risks". Such a statement should include information on contingent liabilities, as well as the sensitivity of budget estimates and public debt projections to key macroeconomic assumptions. Countries should consider disclosing in that context the fiscal risks arising from any new guarantees granted to the financial sector.

Risk Management

The rise in contingent liabilities heightens the need to design fiscal policies that can mitigate risks, from both a macroeconomic and a regulatory standpoint. To discuss these issues, we will devote a session tomorrow to the appropriate policy responses to fiscal risks arising from contingent liabilities, particularly those linked to failing private sector institutions that have to be bailed out with public resources. This is a crucial area, which requires a legal and administrative framework that clearly identifies a government entity as responsible for fiscal risk management.

Such a centralization of fiscal risk management would help policymakers take into account possible interactions among different sources of risk, although the desirable degree of centralization depends on country characteristics and circumstances. The recent international financial crisis, however, has made it clear that the ministry of finance should be able to monitor and identify balance sheet positions and vulnerabilities of the private sector, and have a significant role in monitoring its risk-taking activities.

Fiscal risk mitigation begins, of course, with sound macroeconomic policies and strong public financial management systems. Beyond this, risk mitigation could involve a combination of insurance and other mechanisms providing for governments to take on contingent liabilities only when there is a clear justification for them. Given the current environment and the prevalence of guarantees being issued, it is important that guarantee proposals be appropriately scrutinized and accounted for in the budget process.

Indeed, while decisions to commit public resources should be reflected in the budget at the time they are made, contingent obligations are characterized by uncertainties related to the timing and extent to which they may become due. This creates a possible "bias" in favor of such guarantees. For example, under cash budgeting, direct subsidies reflect their full cash impact, whereas guarantees may be viewed as "less expensive." We will hear later today about risk management practices followed by Sweden, which has a well-developed framework governing the issuance of guarantees and their integration into the budget process, and for minimizing incentives and opportunities to provide subsidies through guarantees.

Budgetary practices that could be implemented to mitigate potential costs associated with guarantees will be discussed in more detail during the Conference. But good practice would include some of the following principles:

- Under cash-based budgets, at least the expected cost of cash payouts to meet calls on guarantees during the budget year should be appropriated. This could take the form of either a general appropriation for contingencies, or a separate appropriation for guarantees.

- Alternatively, the full expected NPV cost of guarantees could be appropriated. This might reduce the bias in favor of guarantees, but would require reliable estimates of expected cost.

- A fee-based guarantees fund could be set up to meet the cost of calls on guarantees. This might facilitate tracking the experience with guarantees, and strengthen the government's credibility as a contracting partner.

- Lastly, an annual quantitative limit on guarantees could instill discipline in the allocation of guarantees among competing projects.

Concluding remarks

Let me conclude by saying that the work on identifying, disclosing and managing fiscal risks is even more important now as losses and risks to banks' balance sheets are being transferred to the public sector. And I hope that the discussion we will have in the next couple of days can help identify possible gaps in existing risk management frameworks and propose new practices that should be implemented.

All that remains is for me to welcome you again to this conference and to encourage you to speak freely and openly on this very rich and important topic. As in previous occasions, this is a closed-doors conference and information and opinions given will not be attributed or passed on to the press.

I look forward to hearing your views on these important issues before us.

Thank you.