


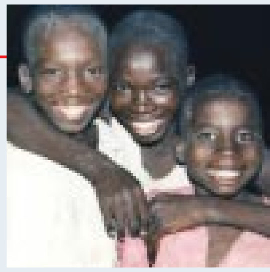

Dialogue on Globalization

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# New Steps to Faster and Broader Debt Relief for Developing Countries

FRIEDRICH EBERT STIFTUNG

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## *Dialogue on Globalization*

*Dialogue on Globalization* contributes to the international debate on globalization – through conferences, workshops and publications – as part of the international work of the Friedrich-Ebert-Stiftung (FES). *Dialogue on Globalization* is based on the premise that globalization can be shaped into a direction that promotes peace, democracy and social justice. *Dialogue on Globalization* addresses "movers and shakers" both in developing countries and in the industrialized parts of the world, i.e. politicians, trade unionists, government officials, businesspeople, and journalists as well as representatives from NGOs, international organizations, and academia.

*Dialogue on Globalization* is co-ordinated by the head office of the Friedrich-Ebert-Stiftung in Berlin and by the FES offices in New York and Geneva. The programme intensively draws on the international network of the Friedrich-Ebert-Stiftung – a German non-profit institution committed to the principles of social democracy – with offices, programmes and partners in more than 100 countries.

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# 1. Introduction

We are increasingly recognizing that our global economy has become more interdependent. But a major shortcoming of the present system is the absence of instruments for handling common problems of collective action in areas in which we face mutual challenges.

Sovereign bankruptcy, meaning insolvency of a country is one of the common problems in the global economic system. In a globalized world, the failure of a sovereign nation to service its citizens and debtors has the potential to create economic instability throughout a region or even to affect investor's confidence in the world economy. The current international financial system has made developing countries particularly vulnerable. Recent financial crises have shown that developing countries who have liberalized their financial markets and are increasingly indebted abroad put themselves at risk of volatile international capital markets. Even if their economic fundamentals look promising, a sudden change in financial investor's sentiment on the global level, can for instance lead to huge increases in interest rates and consequently to a high burden of debt. That is why in a situation in which sovereign nations are facing unsustainable external liabilities it becomes crucial to have global instruments in place to avoid spill over effects to other countries.

However, present debt management has been characterized by unhampered creditor power with dire consequences for debtor countries. International debt initiatives are granting overly small reductions too slowly and this has prolonged rather than solved the problem. The lack of an international institution to tackle sovereign bankruptcies leads to a disproportionate impact on vulnerable groups in developing countries. Creditor power in present debt negotiations leads to a situation in which only debt services to foreign creditors are at stake, but not the obligations of the indebted country to its citizens in providing social services such as pensions, education or public health.

In the recent past, specific proposals for a new international debt workout mechanism, the so called fair and transparent arbitration process (FTAP) that was advocated by international organizations like UNCTAD, or non-governmental organizations, such as the Jubilee Campaign, were often ignored in the international discussion.

**The fair and transparent arbitration process (FTAP) was advocated by international organizations like UNCTAD and non-governmental organizations, such as the Jubilee Campaign**

But the general idea of the concept gained sudden momentum, after a passing remark by US Treasury Secretary Paul O'Neill in a testimony given to the US Senate on the financial consequences of the terrorist attacks of September 11. Mr. O'Neill's comments were quickly taken up by the First Deputy Managing Director Anne O. Krueger of the IMF who proposed the creation of bankruptcy procedures for sovereign nations facing unsustainable external liabilities.

Given the recent development, there might be new hope for tackling the debt burden of developing countries. This is why the New York Office of the Friedrich Ebert Foundation in cooperation with the German network *erlassjahr.de* has taken a initiative in the UN Financing for Development process and convened a group of senior analysts and policy makers to discuss ways how the FTAP approach can be implemented at the international level.

**This publication mainly describes the concept of FTAP and explains the current political state of affairs in the international discussion**

This publication mainly describes the concept of FTAP and explains the current political state of affairs in the international discussion on new debt workout mechanisms. We hope that this will act as a starting point for further substantial debate to achieve faster and broader debt relief for indebted developing countries.

The study has been written by Jürgen Kaiser *(Erlassjahr.de)* and Frank Schröder *(FES New York)*.

New York, December 2002

*Manfred Bardeleben*
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# 2. The long and difficult history of debt relief

In August 2001 the World Bank released an update on the state of the Multilateral Debt Relief Initiative for the so-called Heavily Indebted Poor Countries (HIPC). For the first time, after the initiative's general overhaul at the Cologne G7 Summit, the bank acknowledged in this report that additional relief beyond the HIPC benefits would be probably necessary for some countries.

**In 1996 the HIPC was developed. For the first time it was acknowledged that it made sense to define the threshold of debt sustainability, rather than defining write-off thresholds**

This message is not a surprise to those familiar with international debt problems. The excitement about it is rather that it comes at the end of a twelve year long mission-creep towards ever extended and ever insufficient debt-relief. The last time official creditors provided some breathing space for the poorest countries was through the "Toronto Terms" in 1989. Since that year, debt write-off frameworks have been consistently extended as no one framework developed by the G7 at their respective annual meetings – London Terms of 1991, Naples Terms of 1994, Lyon Terms of 1996 – has been able to lead the poorest countries to comply with their annual debt service. Then, in 1996 the Heavily Indebted Poor Countries' Initiative (HIPC) was developed by the Bank and the Fund. For the first time it was acknowledged that rather than defining write-off thresholds it made sense to define the thresholds of debt sustainability, and to consequently provide for the cancellation of any foreign debt of beyond this threshold.

The Initiative was launched with much fanfare by Multilateral and Bilateral official creditors. Bank President Wolfensohn even took recourse to quasi-religious terminology by labeling it a "good news for the poor".

The not so good news came to light fairly quickly when the sustainability thresholds defined by the creditors turned out to be so restrictive, that out of an already restricted group of 41 eligible countries only 6 were considered as being in need of HIPC-relief. In the light of this, at the Cologne summit the sustainability thresholds were redefined. Up to 36 countries were expected to qualify for relief under the renewed scheme. Out of these, 26 have received assurance as to what extent they would actually see their debts cancelled, as of this writing (August 02), while just five of them have actually seen their debt partly cancelled.

The World Bank's document in August 2001, however, revealed a deeper dilemma: it was acknowledged that some countries would not be able to fulfil the extremely optimistic assumptions which the Bank's analysts had built into the design of the relief initiative. It is impossible for the 22 countries to reach an annual 5.6% real GDP growth or 8.9% export growth over the next ten years. Only under these assumptions – more than unrealistic in the face of the global economic slowdown before and after Sept. 11th – would the medium term sustainability be reached.
At the 2002 spring meetings of the Bretton Woods Institutions creditors have agreed to mobilize an additional one billion US$ for the HIPC countries. The necessary infusion of additional financing should have been expected due to the

too optimistic growth expectations in the HIPC relief initiative and can not be explained as a result of unforeseen exogenous economic shocks.

Unrealistic expectations that cannot be met are not the only inconsistency in the current international debt relief mechanisms. In fact, HIPC has never been the “solution to the South’s debt crisis” , as labeled by its authors, simply because it deals only with a minor fraction of the foreign debt of the countries in Asia, Africa and Latin America.

- At most, it will eliminate some 70 billion US-$ in debt service obligations over the next three decades. The end-2000 debt stock of all developing and emerging market countries reached a level of approximately 2500 bn US-$.

- The 41 countries deemed eligible for HIPC-relief are less than half of those 86, which the World Bank’s “Global Development Finance 2002” categorizes as “Severely Indebted” or “Moderately Indebted”, i.e. as having a critical or even alarming debt problem. The enclosed list reveals that HIPC tends to serve the smaller – and easier to relieve – economies

Table 1: **Debt-ridden countries inside and outside the HIPC-framework**

| | **Severely Indebted Low Income Counties (SILICs)** | **Severely Indebted Middle Income Countries (SIMICs)** | **Moderately Indebted Low Income Countries (MILICs)** | **Moderately Indebted Middle Income Countries (MIMICs)** |
|---|---|---|---|---|
| **HIPC** | Angola, Burundi, Cameroon<br>Central African Republic, Chad, Comoros, Congo (DR), Congo (Rep.), Cote d’Ivoire, Ethiopia<br>Guinea, Guinea Bissau<br>Lao PDR, Liberia, Madagascar<br>Malawi, Mauritania, Myanmar, Nicaragua, Niger, Rwanda<br>Sao Tome & Principe<br>Sierra Leone, Somalia, Sudan<br>Tanzania, Zambia | Guyana | Burkina Faso<br>Cambodia<br>Gambia<br>Ghana<br>Kenya<br>Mali<br>Mozambique<br>Senegal<br>Togo<br>Uganda<br>Yemen | Honduras<br>Bolivia |
| **Non-HIPC** | Benin<br>Indonesia<br>Kyrgyz Republic<br>Nigeria<br>Pakistan<br>Tajikistan | Argentina<br>Brazil<br>Bulgaria<br>Gabon<br>Jordan<br>Peru<br>Syria | Haiti<br>Moldova<br>Mongolia<br>Uzbekistan<br>Zimbabwe | Algeria, Belize, Bosnia and Herzegovina, Bulgaria, Chile<br>Columbia, Croatia, Estonia, Hungary<br>Jamaica, Lebanon<br>Malaysia, Mauritius<br>Panama, Papua New Guinea, Philippines, Russia, Samoa<br>St. Vincent and the Grenadines<br>Thailand, Tunisia<br>Turkey, Turkmenistan, Uruguay, Venezuela |

*Source: Global Development Finance 2002*

The line between HIPC and Non-HIPC marks the broad distinction between countries which have access to debt relief, albeit inadequate, and those, which are still expected to "grow out of their debt". The decision regarding to which category a country belongs is based on the "IDA-only status" of the country in question. If it has been awarded this status, it can qualify for HIPC, provided it is also considered to have a severe debt problem. Alternatively, if the country is instead allowed to borrow exclusively or additionally from the non-concessional IBRD, it does not qualify for either relief under HIPC or in the Paris Club of official creditors. This decision, in fact, is made by the World Bank staff. Not even the Board of the Bank is involved, and there are overly vague criteria for awarding this status, other than the country must fall below a certain annually adjusted income threshold. The second criterion is "access to capital markets", which is neither properly defined nor consistently applied by the World Bank staff. We are dealing with some deeper rooted failure in the management of the international debt crisis, rather than with just a few benchmarks which need fine-tuning.

"Erlassjahr.de" and fellow international debt campaigns understand these fundamental shortcomings are intrinsically related to the imbalanced process of decision making in international debt management. Looking at the relevant fora in which debt is actually negotiated we find that creditors are the ones who define the process as such, set up the rules of the process and decide upon particular cases on the basis of expertise they have commissioned or even produced themselves. While such structural imbalance between the parties in a court case would be completely unimaginable between creditors and debtors within a national context, this setting has been standard procedure between sovereign debtors and their creditors. The following scheme outlines the most fundamental differences between the standards of the rule of law as applied internally in most creditor countries and current sovereign debtors' reality.

Table 2: **Different Standards of the Rule of Law**

| | **Insolvency Principles** | **Sovereign Debtors' Reality** |
|---|---|---|
| **Who decides?** | Impartial decision making by a neutral body | Paris Club procedures (creditors are judge and plaintiff at the same time) |
| **Cash Flow Effects?** | Automatic stay of payment with the start of the process | Continued payment obligations, leading potentially to asset grabbing. |
| **Guiding Principles?** | Survival in dignity must be guaranteed; overrules justified claims to debt service | Collect as much debt as possible; relief refers mostly to unserviced debt. |
| **Who bears the costs?** | Burden sharing according to capacities | Adjustment burden falls on debtors first. |
| **Who participates?** | A comprehensive solution, involving all creditors. | Paris Club, London Club, Multilaterals, Non-PC-official creditors, bondholders, block each other; the existing fragmented scheme provides a premium for those which hold out. |

# 3. "A fair and transparent arbitration process for indebted southern countries" – The proposal by international NGOs

Five key elements of a reformed procedure between debtors and creditors would likely lead to more efficient debt management and overcome the structural and ethically questionable imbalance between the parties:

1. A neutral decision making body, which is independent of both parties involved.
2. Comprehensiveness of procedure, i.e. all claims on one particular debtor are dealt with in one comprehensive process, in order to accomplish medium term debt sustainability and to avoid free riders.
3. The right of all stakeholders to be heard before a decision is made.
4. The protection of the debtor's – in this case the most vulnerable sectors of a sovereign debtor's society – basic needs, before debts are collected.
5. The institution of an automatic stay, once an international "insolvency" or "arbitration" case is opened, in order to avoid a creditor's run on the debtor's remaining assets and to allow for an orderly procedure.

**"Erlassjahr.de" and other international debt networks support the internationalization of Chapter 9 of the US Insolvency Code**

How could such a reformed process be introduced? "Erlassjahr.de" and other international debt networks support the proposal made by the Austrian economist Professor Kunibert Raffer in the late eighties. Raffer suggests the internationalization of Chapter 9 of the US Insolvency Code.

This particular chapter establishes an insolvency procedure for debtors with governmental powers (municipalities) within the United States' legal system. All the elements mentioned above are part of Chapter 9, which has been applied with minor reforms since the 1930's in the United States.

An international arbitration panel would need to be added in order to make the scheme work internationally. There is no existing international juridical body with the competence and capacity to resolve debt-payment problems between sovereign debtors and their creditors. The arbitration court should be an ad hoc body, which is composed of an equal number of arbiters from both – debtor and creditor – sides. The appointees then nominate an additional person to allow for decision making through simple majority. This procedure is known in international relations, as it is often applied in cases of bilateral conflicts. The informal character of the arbitration body would be appropriate, as the current debt management also functions without any binding quality in international law, but rather on an ad hoc basis. It is based on the political will of the creditors and the lack of alternatives for the debtor.

The mechanism would thus be highly flexible. It would not need a complex international structure, as the process remains largely in the hands of the parties involved. It might be considered, however, to set up a small technical secretariat at an institution which itself is neither debtor nor creditor – e.g. the United Nations. The secretariat's task would be to support the process of data harmonization according to international standards, auditing, technical support to the arbiters, and organization of the hearings of the stakeholders according to procedural standards.

Even if creditors tend to assume that giving up part of their control over international debt management would put them into a losing position, the arbitration process is likely to let everybody be better off at the end of the day (with the eventual exception of creditors whose loans have been tainted with fraud, and who therefore would shy away from transparency):

- Debt sustainability – for long a cornerstone of the creditor-dominated debt management – could for the first time be assessed realistically. This would at least make it possible that an agreement with a particular debtor country would not need to be overhauled within a few years' or even months' time (as is now common practice with the Paris Club).
- Creditors would find a comprehensive solution to the problems of a particular debtor, without behind-the-scenes bickering by the various creditor groups. While under the current piecemeal approach there is actually a premium for those creditors who show the greatest reluctance in joining into an overall solution through rescheduling or write-offs. A single, comprehensive arbitration process would assure that nobody gets a free lunch.
- Investors could find a really clean sheet when they consider bringing fresh money into a (formerly) overindebted country. They would not have to face the threat of seeing their hard currency being used up to pay old loans. The enhanced attractiveness even of currently highly indebted countries would be the consequence of such an effective firewall between bad loans of the past and the fresh money a country may urgently need.

**A single, comprehensive arbitration process would ensure that nobody gets a free lunch**

**Investors could find a really clean sheet**

When Jubilee campaigns started working for a reformed procedure they called it an “International Insolvency Law”, taking up the wording used by Prof. Raffer. This, however, turned out to be misleading, as it suggested that an international legal framework was the aim. Although it would certainly be useful to have such a framework, it was agreed that if this were ever to come about, it would take several years to install through the many necessary national legal processes.

For example the IMF calculates a timeframe of two to three years towards implementation of its recently proposed debt restructuring mechanism (SDRM). The IMF proposal is described in detail later in this publication. Due to the fact that the existing mechanisms actually lack any legal quality (see above), it could be assumed that a fairer mechanism would not need it, either. Therefore, the term used by campaigners changed from “International Insolvency Law” to “International Insolvency Procedure”.

However, when the debate became more and more international, another important difference of the perceptions of certain terms by Northern and Southern activists came to the surface. “Insolvency” is for Northern ears a somewhat technical, but in any case neutral term. For Southerners, on the other hand, it implied, a significant number of negative connotations, even some form of colonial or racist thinking: bankruptcy, inability to deal with financial matters, the suggestions to be supervised by creditors or donors… Nobody, of course, wanted to promote this kind of thinking.

So a completely different term was looked for. At the first international workshop in early 2000, a new trademark was invented, which is anything but elegant and "campaignable", but for the time being the best and most accurate term, for what activists have on their minds: A "Fair and Transparent Arbitration Process" (FTAP).

Soon thereafter, English speakers disagreed about whether "Process" or "Procedure" was the more precise term. Thereafter, the "P" was often simply dropped. This, however, led to the acronym "FTA" which is shorter, but easily confused with "Free Trade Area" – something debt campaigners certainly do not wish to give any positive connotation to.

(New proposals and suggestions are most welcome.)

# 4. International Insolvency/Arbitration: Arguments and Counterarguments

Common objections have been raised to an alternative framework for the solution of sovereign debt problems through an international insolvency procedure. Some stem from a misunderstanding of the nature of sovereign debt, and some are based on legitimate concerns for the sovereign debtor's fate after he has gone through an international insolvency procedure. The most common ones are being dealt with below:

If one considers only corporate or individual insolvency, this is legally right. But that is precisely why the US Chapter 9 is proposed as a model. Chapter 9 has been designed and implemented in order to deal with the specific opportunities and constraints debtors with governmental powers are facing. Its principles can and should be applied internationally.

**The only reason sovereign countries have to honor international agreements is that they consider the gains to be greater than the losses**

Right – there is none. But this is so in ALL arbitration cases, including those unrelated to debt. Still, arbitration works fairly well in international disputes and as a settling mechanism in the framework of international treaties like the WTO. In all of these cases, the absence of formal enforcement is of no major concern. The lack of an enforcing institution holds also for existing agreements on debt, e.g. with the Paris Club. Agreements between countries and their creditors cannot be enforced in the same way as treaties between individuals within a country. The only reason sovereign countries have to honour international agreements like those over debt payments is that they consider the gains – political, as well as economic – to be greater than the losses they would incur by coming into conflict with those at the negotiation table. Regarding this fundamental deficit of international relations, an arbitration procedure is formally neither better nor worse than the existing creditor-dominated procedures. In practice, agreements reached with broader participation of all parties involved tend to bring about better and more sustainable results (see below). That said, no-one proposes to do away with the Paris and London Clubs for being unable to invade non-complying sovereign debtors.

Paris Club rulings, in fact, happen to be frequently disregarded by individual creditors or debtors. One reason for this is that usually only a selection of a country's sovereign creditors is involved in working out the PC arrangement – normally the OECD countries that also happen to be members of the Paris Club. Other creditor nations, be they Emerging Economies or HIPCs themselves, often see no reason to grant relief to a debtor because an agreement has been set up in which they have had no influence. This is even more the case for private creditors, whom PC members try to involve through "equal treatment clauses"; these rule that a private creditor has to grant the debtor comparable terms to those agreed upon by the PC. Especially at times when private flows to the South are up to nine times the volume of public flows, private creditors tend to accept these kind of clauses even less. In contrast, an agreement that has been worked out with the participation of all parties involved has a much better chance of being honoured by all stakeholders.

**An agreement that has been worked out with the participation of all parties involved has a much better chance of being honored by all stakeholders**

If that were true, no reorganized company could ever get any new loans – which is manifestly wrong, as daily experience shows. It is also wrong for sovereign borrowers: Indonesia got a reduction of its debts in a de facto insolvency in 1969. Again, in the mid-1970s, it had the Pertamina crisis because the public sector had again been able to overborrow. Academic research indicates that this high level of new investments after a far reaching insolvency procedure is not an exceptional case. Interestingly enough, this point is often made by representatives of the International Financial Institutions. The IFIs, in fact, assume substantial new loan inflows into the HIPC countries, after they have received substantial – though insufficient – debt relief under this multilateral initiative. If the IFIs would not build their estimates on those inflows for the post-relief balance-of-payment, the concessions they make under HIPC would even turn out to be more insufficient. Moreover, investors make their decisions first of all by considering the probability of repayment in the future. The debtor's track record regarding the servicing of past loan contracts is one, but by far not the most important aspect they take into account.

On the other hand, they logically see future repayment prospects improved once they can be sure that the debtor will not have to use parts of the hard currency they bring in for servicing old, failed or unprofitable investments.

**An international chapter 9 would not need a new international organization**

It is important to stress that an international Chapter 9 would not need a new international organization, or a costly bureaucracy. Arbitration panels are temporary. Once the task of starting a workable composition plan is achieved, the panel can be dissolved. If further disagreements should develop later on the same persons (or, if necessary, other arbiters) could reconvene to solve them. Theoretically not even an international treaty establishing international insolvency proceedings ratified by all (or the most relevant) creditor nations would be needed as long as all (or the most relevant) creditors are determined to solve the problem. Practically, though, an international treaty would certainly be helpful.

**The proposed panel is comprised of three or five arbiters, plus perhaps the same number of secretarial and technical staff**

What about the technical personnel necessary for arbitration? Both creditors and debtors employ qualified personnel managing reschedulings or other debt related issues. In an international Chapter 9 procedure these people would simply do what they have done so far: negotiate and argue their points. But now they would do so before the arbiters instead of among themselves. As the panel is comprised of three or five arbiters, plus perhaps the same number of secretarial and technical staff per case, one can hardly speak of a huge international bureaucracy, even considering that there will be quite some cases due to the accumulated backlog. In the case of the WTO (which has permanent staff) this concern about new bureaucracies was not voiced at all.

Under an arbitration procedure debtors would still face extensive investigation into their assets, as well as into their past borrowing and governance practices. This would take place under public surveillance, which would enforce more rather than less discipline on debtor governments and civil servants.

However, the disciplinary effect of existing mechanisms has been extremely one-sided. In reality bad borrowing necessarily implies bad lending and this in turn presupposes that there is a bad lender. The need for enforcing discipline not only on the borrowing, but also on the lending side has never been taken into account in existing frameworks.

**Bad borrowing necessarily implies bad lending**

History reveals that the deterring effect of existing mechanisms against bad borrowing has been minimal in the past. Corrupt and oppressive rulers hardly consider long-term repayment or renegotiation aspects when taking out loans for their immediate needs. In contrast again, creditors who in the seventies have handed out “petro-“ and “metrodollars” in large amounts without asking questions, would have been more careful in their lending practices, had they foreseen the upcoming questions in the case of defaults.

This assertion is quite far from the reality of HIPC. Of the five basic principles of an international insolvency procedure, HIPC contains only trace elements of one: There is no independent decision making, no hearing of all stakeholders before a decision on debt relief is made, and the procedure is not comprehensive (see above). The only element of an insolvency procedure, which HIPC has a certain right to claim it honors, is the protection of the basic needs of an indebted country. However, the definitions of “debt sustainability” which have been applied through the scheme’s history are so unrealistically high that particular countries paid even more after they were “relieved” from their debt burden than beforehand. So the conceptual reliance on debt sustainability as a guiding principle, which HIPC has applied for the first time in modern debtor-creditor-relations hardly translates into economic reality.

This obvious failure is not haphazard. It mirrors the fundamental defect that a sustainable solution in a conflict can simply not be achieved if one of the two parties is judge in its own cause. Therefore, a “reformed Paris Club” would be no solution. A creditors’ cartel can in the best of all cases act benevolently towards a debtor. It can never do justice. This is why impartiality is one of the key elements of the rule of law.

Not totally right. When Indonesia was at the brink of default in 1969 and the Paris Club lacked the instruments and procedures to relieve the country of some unbearable debt, but had, at the same time a strong interest in stabilizing the military dictatorship in a strategically important corner of the world, they did not lack imagination that they obviously do today. The PC contracted an experienced banker to work out a compromise which was coherent (even binding to the Soviet Union, which happened to be an important creditor to Indonesia) and acceptable to everyone. The "mediator" came up with a solution which actually neglected all existing principles of the Paris Club. In the end he was able to convince all parties to accept a nearly total write-off of interest on past claims. Though this "mediation" was not arbitration in the strict sense of the word, it contained many of the basic elements, and highlighted the superiority of negotiated solutions over those enforced by creditors.

# 5. Unable to take the lead? The Bretton Woods Institutions and the rule of law in international financial relations

For many years proposals regarding bankruptcy procedures to tackle the burden of unsustainable sovereign debt in developing countries were entirely ignored by the Bretton Woods Institutions. For example at the World Bank NGO advocacy campaigns to promote the general idea of the FTAP proposal were rejected as unfeasible and incompatible to the rule of law in international financial relations.[1]

However, the situation changed in 2001 after a passing remark by US Treasury Secretary Paul O'Neill. In testimony given to the US Senate on the financial consequences of the terrorist attacks of September 11 the general idea for a new debt workout mechanism gained sudden momentum. Mr. O'Neill's comments were quickly taken up by the First Deputy Managing Director Anne O. Krueger of the International Monetary Fund (IMF)who proposed the creation of bankruptcy procedures for sovereign nations facing unsustainable external liabilities.

Her proposal for a so-called Sovereign Debt Restructuring Mechanism (SDRM) is a breakthrough in the international discussion on debt management mechanisms. The fact that the idea of a bankruptcy procedure has now arrived at a prestigious financial institution such as the IMF, invalidates the popular objection that such a principle would work against the debtor country by cutting it off from capital markets.

**The IMF proposal for a so-called Sovereign Debt Restructuring Mechanism (SDRM) is a breakthrough in the international discussion on debt management mechanisms**

Against this background it should be mentioned that the recent occurrence of financial crisis in the world economy has challenged the capacity of the IMF in

1 Further information on the arguments of the World Bank against the FTAP proposal can be found on the webpage of erlassjahr.de (www.erlassjahr.de) . The erlassjahr campaign had introduced the FTAP concept to the President of the World Bank James D. Wolfensohn, but received a negative evaluation of the proposal from World Bank staff.

crisis prevention. Developing countries which have liberalized their financial markets are in crisis situations exposed to capital flight literally by everybody who holds financial assets in the afflicted country. The capacity of the affected government to restore some stability in the economy is very limited, since the countries do not have sufficient financial resources at their disposal to counteract capital flight. This means that they are depending on new loans and rescue packages by institutions such as the IMF. However, there has been recent criticism of the intervention strategy of the IMF, mainly by the developed countries. Rescue packages served in the past mostly to socialize debts, because the money was used to pay back private lenders and the afflicted country became a debtor to the IMF to the same extent.

Therefore,it is unsurprising that the industrial countries, as major donors of the Bretton Woods Institutions felt uneasy with the way the IMF has handled financial crisis in the past. They were left with the post-crisis risk that the debtor in the end will be incapable of paying back the loans to the IMF.

Against this background, the proposal of the IMF management for a Sovereign Debt Restructuring Mechanism (SDRM) can be understood as a way to promote private sector involvement to achieve burden-sharing and prevent debt crises. The goal is to involve private lenders by having them to accept the restructuring of debts when the debtor is unable to serve its obligations. It serves also as a crisis prevention strategy, since private creditors will be more cautious in their lending activities, given the fact that a bailout solution provided by the IMF is less likely. Nevertheless, the SDRM proposal is in many aspects quite different to the FTAP approach as advocated by civil society organizations. The table 3 contrasts the IMF position with that of the NGOs.

**The IMF's SDRM proposal is quite different to the FTAP approach by civil society organizations**

As shown in Table 3 there are quite different features in the FTAP proposal as suggested by NGOs in comparison to the SDRM approach of the IMF. It is questionable why a process that is to lead to debt sustainability does not consider all claims on the debtor. The lack of explicit reference to all types of debt, including multilateral and bilateral official debt in the IMF proposal raises the general question if the Fund is the appropriate institution to preside over such a process. The IMF is a creditor itself and represents in a disproportionate way those countries where loans originate, even if private loans, in contrast to the debtor countries.

Although the Fund has refrained from the idea of putting itself into a decision-making role by acknowledging that this should be carried out by the parties (the debtor and a qualified majority of creditors), the IMF would get a bigger role through an SDRM procedure.

The creation of a so-called independent Dispute Resolution Forum (DRF) takes on only the role of an arbiter in the process by interpreting and applying the SDRM framework. However, the IMF would be given the crucial role to determine the threshold of debt sustainability and have the decision-making power to grant a debtor country's request – for or extension of a stay. In this context it is worthwhile to underline that a conservative sustainability threshold is not an element of generosity on part of creditors. The success of an arbitration procedure depends

Table 3: **Contrasting Elements of FTAP vs. SDRM**

| Issues | SDRM- Proposal (IMF) | FTAP-Proposal (NGOs) |
|---|---|---|
| *Which debts are dealt with?* | Sovereign debt owed to domestic residents and foreign debt to non-residents.<br>Multilateral and Bilateral Official Debt are not explicitly considered | All sovereign debt owed to domestic residents and foreign entities.<br>Private Debt affecting the balance of payments can as well be included. |
| *Who defines the threshold of a nation's debt sustainability and need for debt relief?* | Executive Board of the IMF | Neutral independent arbitration panel nominated by the parties, plus one additional person.<br>Expertise provided by a qualified independent institution, which has no relationship with debtors or creditors. |
| *Who operates the framework for debt restructuring?* | Dispute Resolution Forum (DRF) hosted by the IMF, but independent of the IMF's Executive Board and Staff. | Independent arbitration panel, based on guidelines derived from Chapter 9, US-insolvency code |
| *What is the role of conditionality and debt standstill?* | Debt workout mechanism and temporary debt standstill is conditional on IMF structural adjustment program. | Independent panel decides on debt relief conditional on good governance and credible poverty reduction.<br>The declaration and international acceptance of debt standstill is an essential first step of the FTAP |
| *What is the legal foundation for the debt workout mechanism?* | Statutory framework that has the force of law universally. Possibly by establishing the framework through an amendment of the IMF's articles. | Although legal underpinnings are desirable, a legal foundation in international law of the FTAP process is not necessary for its functioning.[2] |
| *What is the crisis prevention effect of the mechanism?* | Private lenders are more cautious in lending, since they can not expect to be bailed out by the IMF. | Private and official creditors would not only loose the perspective on bailouts. The transparent and balanced procedure would discourage irresponsible lending. |
| *What is the timeframe for the implementation of the new mechanism?* | The proposal is currently under discussion at the IMF and will not be in place, according to Ms. Krueger, for another two or three years. | The new framework could be applied immediately in form of ad-hoc arbitration or through a mediation process like it was applied in Indonesia in 1969. |

on a level of debt cancellation at a truly sustainable level. Against the background of the HIPC Initiative for the poorest countries, we could see how an ambitious debt relief program became toothless because creditors tried to minimize their expenses regardless of the debtor's situation.

Furthermore, according to the IMF proposal, the debtor country would have to accept limitations on its domestic and foreign policies in form of conditionalities directly imposed by the IMF. Excessive conditionalities, in number and in coverage,

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2 If a legal framework is being established, changes in national credit laws, particularly in the US and UK could be an alternative for an Amendment of the IMF's articles.

**An IMF monopoly on defining macro-economic structural adjustment programs violates the basic principle that a creditor must not be the one to judge the debtor**

are some of the main consequences of developing countries repayment problems. The Fund has acknowledged itself, that it has contributed to countries' economic crisis through its authoritative "advice" through structural adjustment of the past. Furthermore, an IMF monopoly on defining macroeconomic structural adjustment programs violates the basic principle that a creditor must not be the one to judge the debtor. Instead, the neutral arbitration panel needs to define conditionalities, which the debtor has to comply with in order to qualify for debt relief.

In other words, Ms. Krueger's proposal does not envisage a truly neutral arbitration panel with far reaching competence over the whole debt workout procedure. Instead, the limited area of authority of the Dispute Resolution Forum gives the technical expertise of the Fund excessive weight, and the institution the ultimate decision making power in the debt restructuring process.

That's the main reason why the IMF proposal does not fully recognize Chapter 9 of the US insolvency code. In the FTAP proposal based on Chapter 9, the debtor nation has the sovereign ability to file for a stay or, alternatively, to declare the country insolvent. The petition for and judgement on the stay will be considered by the nation itself, and the debtor will be unequivocally entitled to stay if requested. Endorsement of the stay should be the privilege of the neutral institution and not of a single creditor like the IMF.

In conclusion, we can say that the Fund has claimed within the SDRM approach all major decision making power and some new responsibilities for itself. The IMF proposal does not treat debtors more fairly as the current debt restructuring practices. The emphasis on a universal legal foundation and long-term timeframe for implementation will not help highly indebted countries in the nearer future. In other words, ad-hoc arbitration like in the FTAP approach or a similar mediation process like it was successfully applied in Indonesia during 1969 will not be available in the near future for countries like Argentina, nor the poorest countries who desperately need immediate debt relief.

# 6. Perspectives for broader debt relief in the UN Financing for Development process

With the Financing for Development (FfD) conference in March 2002 in Monterrey, Mexico the United Nations held for the first time in its history an event that addressed key financial and development issues. Relevant topics in the conference were six thematic areas around which the FfD negotiations had focused:

- Mobilization of Domestic Resources
- Foreign Direct Investment
- Trade
- International Financial and Technical Cooperation
- External Debt
- Systemic Issues

By raising its voice on Global Finance the UN entered an arena that on the multilateral level is mainly guarded by the Bretton Woods Institutions (BWIs). In this regard, the engagement of the UN on these issues shows that economic development is strongly linked to global governance.

The FfD conference was unique in the sense that it followed a multi-stakeholder approach, and for the first time brought together the UN, the Bretton Woods Institutions (BWIs), the WTO plus business entities and civil society to find common solutions for the problems of development financing.

**A stronger role of the UN on economic governance as an outcome of the Monterrey FfD process**

In particular, the developing countries which had initiated the conference built their hope on a stronger role of the UN on economic governance as an outcome of the FfD process. In their view, a more participatory approach could democratize the decision making process on global governance issues in order to make the international economic order less asymmetric or more equitable.

After almost two years of negotiations in the FfD preparatory process, governments finalized the so-called Monterrey consensus in its last FfD preparatory session in January 2002, reflecting the minimal consensus of governments on the six thematic areas. Heads of States officially adopted the document in the UN Financing for Development conference in Mexico.

**Build on UN precedence by including sovereign debt workout procedures, an independent mediator, and a non-statutory basis for the mechanism**

The idea of a Fair and Transparent Arbitration Process (FTAP) had been very actively promoted in the runup to the Monterrey Conference, particularly by NGOs, which throughout the whole process had good opportunities to make their voices heard. But also the developing countries represented by the Group of 77 (G77) advocated solutions for a new debt workout mechanism. The G77 saw the chance to challenge the leadership of the IMF which was dominating the public discussion with the Krueger proposal on bankruptcy procedures for unsustainable debt. In particular, a number of the larger developing countries were in favor of an alternative proposal to be adopted in Monterrey that would build on UN precedence by including sovereign debt workout procedures, an independent mediator, and a non-statutory basis for the mechanism. In the negotiations on the Monterrey Consensus the G77 suggested the following wording for the systemic issues chapter of the document regarding debt restructuring:

*"To promote fair burden-sharing and prevent moral hazard, we welcome an international debt workout mechanism, modeled on domestic bankruptcy procedures including independent arbitration, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner."*[3]

However, the suggestions of the G77 were strongly opposed by the industrial countries and, in particular, by the United States in the following discussion. The finalization of the document took place with enormous pressure applied by some governments on unresolved conflicts in the Monterrey document. The political risk for developing countries was that fighting a tough battle on some of the con-

3 Intervention by the Group of 77 occurred in the final negotiations of the Monterrey consensus. It is important to mention that the G77 achieved in the negotiations to strike off a previous reference in the text to the IMF proposal.

troversial issues may have provoked a walkout of some countries from the process. In particular, the innovative and far-reaching proposal to establish an international debt workout mechanism modeled on domestic bankruptcy procedures, including independent arbitration lacked the political will by many developed countries. Therefore, the paragraph on new debt workout mechanisms was formulated in a way that reflected the minimal consensus of all governments:

*[...] " we would welcome consideration by all relevant stakeholders of an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner."*

Although, reference to independent arbitration and domestic bankruptcy procedures were dropped, the fact that the FTAP proposal has gained support by many governments in the FfD process is a success.

In general, the Monterrey consensus reflects the fundamental issues developing countries face in financing their development, namely mobilizing more resources on the one hand and reducing their vulnerabilities to international financial markets. Although the declaration does not present policy options to tackle these challenges, the fact that heads of state gathered in Monterrey in March 2002 to discuss the future of global finance and governance could open a new chapter on development cooperation.

**All governments have agreed to a strong follow-up mechanism for the FfD conference on the level of the UN Economic and Social Council (ECOSOC) and the UN General Assembly**

The process has already built important bridges and the Monterrey conference will be only a starting point of this development, since governments have committed themselves in Monterrey to stay engaged in the FfD follow-up process. It is important that all governments have agreed to a strong follow-up mechanism for the FfD conference on the level of the UN Economic and Social Council (ECOSOC) and the UN General Assembly. All stakeholders, including business entities and civil society will be part of the process. Governments and the Bretton Woods Institutions have agreed to dedicate the FfD follow-up process to the implementation of the Monterrey commitments. This has opened a main avenue to expose the developed countries to the reform proposal for a new debt workout mechanism. Debt has been the largest source of capital flows to developing countries in the past 50 years. According to the World Development Indicators[4] of the World Bank the total indebtedness of developing countries at the end of 1999 amounted to $ 2.6 trillion representing 42.5% of their GDP that year. In the wake of this poor record it becomes clear that a strategy for how to manage debt restructuring must be a priority in the further Financing for Development process.

The FfD follow up also aims to achieve greater coherence between the Bretton Woods Institutions and the UN and this will give the opportunity to challenge the IMF proposal for a Sovereign Debt Restructuring Mechanism (SDRM). The SDRM concept as presented by Ms. Krueger envisages a strong role for the IMF by establishing its own Executive Board as a kind of spin doctor of the new conflict resolution mechanism. The simple question that should be asked is why the new

4 World Bank 2001, World Development Indicators, Table 4.16

mechanism has to be located at the IMF at all? Even if the amendment to the Fund's Article of Agreement were the legal basis for the enforcement of the proposed SDRM approach, it need not be located anywhere near the institution itself. Why should it, for example, not be established in the UN or at the International Court of Justice in The Hague? If the IMF is honestly interested in an impartial decision making process as stated by Ms. Krueger, a mechanism outside the IMF would be more rational. The Fund as an important creditor should always be welcomed to bring its expertise into a reformed or impartial debt workout mechanism. However, it must never again be in a situation to dominate the debt renegotiation process. The FfD follow up process with its transparent structure and participation of all stakeholders, including business sector and civil society, would be an appropriate forum to discuss solutions for an independent and fair debt workout mechanism.

It is unquestionable that global conferences play an important role in political discourse independent of the results on paper. In the FfD process new debates emerged at the international and national level, sharpening public perceptions of global problems. Public opinion and pressure are an important factor in achieving political solutions. Although the Monterrey document contains no specific commitments for the developed countries to raise Official Development Assistance (ODA), public protest partly prompted the United States and the European Union to announce a rise in their aid budgets at the UN Monterrey conference.

With respect to an arbitration process for further debt relief, it is the US that particularly objects to the reform proposal. The US is of course not the only government opposed to the initiative, other countries may possibly be in line with the US rejection but not going public.

The United States, which at first supported the IMF proposal by Ms. Krueger, developed their own preferred alternative for debt relief. The US Undersecretary of the Treasury, John Taylor, presented a concept of requiring bond contracts to include collective action clauses that allow the terms of bonded debt to be renegotiated when the debtor is unable to service its liabilities. This more market-oriented proposal is not a real alternative to an arbitration process, since it is limited to new debt contracts. The existing debt burden of developing countries, from which they desperately need relief, would not be affected. Moreover, private lenders are not presently voluntarily including collective action clauses in their debt contracts so that even if they would be made universal, it would take many years until there would be a universal legal framework to allow countries to claim for debt rescheduling through this proposed mechanism.

**The UN Financing for Development follow-up process could be the forum in which a fair, transparent and independent new debt workout mechanism will be brought forward**

In conclusion, we can say that given the fact that sovereign bankruptcy is one of the common problems in the global economic system and that it has the potential to create economic instability throughout a country or region, the implementation of solutions to tackle this problem are needed immediately. Because it is crucial to handle common problems with global instruments, a multilateral response is needed. Therefore, the UN Financing for Development follow-up process could be the forum in which a fair, transparent and independent new debt workout mechanism will be brought forward. It should be generally accepted that an impartial arbitrator would be necessary that could be either a permanent institution or an ad hoc entity created each time an intervention is needed. Once private lenders are convinced that rescue packages are history, even they will recognize the value of dealing orderly with payment problems, as opposed to the disorderly process as we can currently see in Argentina. This would lead to a situation in which the crisis is not exclusively paid for by the indebted country's citizens since the provision of basic social services such as pensions, education or public health could be maintained.

The following final section is an example what a consultation proposal for debt negotiations could look like by referring to the concrete situation in Ecuador. It does not present a proper arbitration framework, but is rather an intermediate step by applying the basic principles of the FTAP concept.

# 7. An eventual first step: The Consultation proposal for Ecuador

The negotiations between the Ecuadorian government and its official and private creditors have not brought a satisfactory outcome with substantial debt relief to incite a socially and ecologically sustainable economic new outset. The results of the various negotiation rounds do not correspond to the objectives of a long term solution. Moreover, they include three inconsistencies:

1. The various debt restructuring negotiations have brought about an unbalanced relation between the different creditors. While private creditors accepted a moderate debt stock reduction effectuated by bond holders, the official creditors in the Paris Club did not grant any debt relief of either the nominal debt or of the Net Present Value. Multilateral Debt is not subject to any negotiations at all.

2. Essential creditors – the IMF and the Worldbank – are acting as policy advisors with considerable power to impose their conditions and even sanctions upon the debtor.

3. The debt negotiations with cross conditionalities are set within the processes of structural adjustment. These have been implemented with such haste that in recent years they have contributed to the deterioration of the social situation and limited the possibility of finding a durable response to the problem of external debt.

**Debt arrangements are determined from the creditors' will rather than the debtor's actual capacity to pay**

The above points suggest that debt arrangements are determined from the creditors' will rather than the debtor's actual capacity to pay its debt services. These inconsistencies are currently responsible for the insufficiencies of the present debt management, among other problems. Moreover, private creditors often distrust official creditors in the current system.

These facts jeopardize the pursuit of a sustainable solution. Debtor countries, persistently reach the point where they are not able to pay their debt services in a sustainable way, and find themselves in the painful situation of having to break agreements. This seriously affects their international credibility. Therefore, a sustainable solution for Ecuador, coherent among all creditors, would also correspond to the fundamental interests of the creditors themselves, founded on both the financial and social stability of the country, and the equal treatment of all creditors.

**The Ecuador consultation wants to create a sheltered space within a predetermined timeframe**

In this context the consultation proposal for Ecuador suggests the implementation of an international consultation to openly discuss a sustainable solution to the debt problem with the guiding idea of the debtor's actual capacity of payment. It is not the aim to come to specific agreements between creditors and debtors. Rather, the consultation wants to create a sheltered space within a predetermined timeframe to enable an open discussion about issues and proposals that otherwise could not be tackled.

The consultation is inspired by similar past experiences in which the involved groups were given the possibility to discuss possible alternatives calmly and thoroughly . This model of reunion was recommended on earlier occasions, mainly at a time when the need for fundamental reforms was recognized, yet the debate among the relevant authorities had ground to a halt. One important example was the consultation of the Swiss and the Swedish governments in 1995, which gave important inputs to what was later to become the HIPC-initiative for the *Heavily Indebted Poor Countries*. At the start of the consultation, debt relief of multilateral debt was a taboo, yet it became possible within the new framework.

With regard to the creditors' large mistrust of the good will and capability of the Ecuadorian government in transforming debt relief into effective poverty reduction, the consultation also gives the government of Ecuador the chance to present its own plans, which should then be assessed according to international standards and programs for the effective reduction of poverty. At the same time, mechanisms can be established for the Ecuadorian civil society to participate in visualizing possible results, and to crystallize an appropriate strategy to combat the structural problems of poverty. This consultation can advance this direction and establish new mechanisms that reach beyond the less participatory options followed thus far in the social policies of the Ecuadorian government.

Moreover, considering the vital co-responsibility of the creditors – governments, banks and enterprises – in the debt problem of underdeveloped countries like Ecuador, the active participation of representatives of civil society of the industrialized countries should also be made possible.

The consultation will then open the door for a co-ordinated effort among all actors involved in the debt problem.

Representatives from all relevant creditor groups – private bilateral, and multilateral – should be involved in the consultation. In the particular case of Ecuador, this refers to the association of Ecuadorian creditors, governments of the Paris Club, and the most important multilateral financing organizations (MFOs) such as World Bank, IMF, and IDB. The MFOs are clearly part of the creditors and cannot be incorporated as neutral actors or in a guiding position.

The Ecuadorian government must be involved, represented by the official delegation for debt negotiations, and those delegates of public administration that can become relevant during the process, both in the process of negotiation and in the resource management of liberated funds, i.e. of the social and educational sector.

Following the same logic as mentioned above relevant forces of Ecuadorian civil society should take part, especially those organizations that in the past have actively worked on the issue of Ecuador's foreign debt, as well as representatives from NGOs that could benefit from the liberated resources. Moreover, both grass roots organizations that work with the poorest, and Human Rights institutions should be heard to get a complete picture of the social situation in the country.
To complete the presence of civil society in the course of the consultation, organizations from civil society in the creditor countries should be included to take part, especially those organizations that have shown interest in the economical and social situation in Ecuador and issues of external debt. However, the participation of Northern civil society should be determined by explicit wishes of civil society groups in Ecuador.

The list of participants should also include scientific experts in the fields of all issues taken up; participants whose knowledge and advice is indispensable in obtaining the most fruitful results from this dialogue.

Finally, it is essential for the process to be guided by a competent and neutral authority, one which is regarded by all participants of the consultation as being independent, and able to make final recommendations. This could be some UN department, or a church institution such as the Latin American Episcopal Conference or the Latin American Council of Churches. It should also be analyzed whether similar to the role H.J. Abs played in the debt relief negotiations with Indonesia in 1970 a renowned person who does not hold personal interests in these negotiations could be a facilitator.

**Framework**

The consultation should take place following the invitation of one or more creditor governments of the Paris Club. The venue of the meeting could be one of the inviting countries, on a date before the next round of negotiations between the Ecuadorian government and the Paris Club.

Additionally, consideration should be given to asking for the auspices of one or more institutions of the UN-system, such as UNICEF or UNDP – insomuch as their neutral positions do not limit the discussion of issues that are not usually subject to formal negotiations.

The consultation should not last longer than two days. Its central issues and the way to handle them should be dealt with in fora that allow an open and genuine discussion and produce binding recommendations other than of a simply declarative nature. The participants should formally commit themselves to intervene at all times with the purpose of achieving an effective discussion on all issues included in the agenda; this would impede the rise of preferential topics which would jeopardize the success of the event.

The results of the consultation could be published if considered useful. Equally, in order to guarantee the secrecy of the consultation process itself, public pronunciations should preferably be made after the consultation and, as far as this is possible, in mutual accordance with all participants.

**Components of the program**

With regard to the preparation of the program of the consultation three key points, which are based on the central issues at hand are proposed:

- Analysis of Ecuador's medium and long term solvency and actual capacity of payment – take this as the basis for starting negotiations in the financial area, incorporating conceivable safeguards and clauses of contingency to meet the case of future external shocks that affect the capacity of the economy and the Ecuadorian society.
- An agreement on equity between all creditors to obtain a coherent solution that allows greater international co-operation. This point also includes the prevention of a future moral hazard both from the part of the creditors and from the part of the debtor.
- Establishing a specific sheltered space that for a predetermined period makes open discussion possible on issues and proposals usually not discussed, with the objective of gaining fair and transparent answers, with none of the parties involved assuming the role of a judge.

Additionally, there are certain issues that border the central issue of debt relief and must simultaneously be considered. In order to enhance broad discussion and reach a sustainable solution some space should be kept open in the agenda to consider innovative ideas. For example, central elements of proposals on debt swaps for social and environmental investment involves designing a strategy that grants participation and is free from governmental pressure.

Equally, some additional space should be created to consider and discuss topics that are related to the debt problem, such as economic relations with involved countries. Commercial relations could play a key role. One solution might be to offer the debtor, in this case Ecuador, the possibility of obtaining the resources through enhanced market access, in order to fulfill its commitments.

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