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Sovereign Debt Workout Arrangements

By Kunibert Raffer, University of Vienna[1]

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[1] Associate Professor, Department of Economics,
Hohenstaufengasse 9, A-1010 Vienna, Austria
Kunibert.Raffer@univie.ac.at
http://mailbox.univie.ac.at/~rafferk5

Introduction

The present flurry of discussions on international insolvency - though welcome - may seem odd to people who proposed this solution in the 1980s, especially to those who have consistently advocated it over years, recalling vividly the stiff resistance by the IMF this proposal had met until November 2001. Like touched by a magic wand "counterarguments" brought forward to assert that any application of the principles of insolvency to sovereign debtors would be impossible have disappeared since Krueger's (2001a) first speech. People using them before, including IMF staff - apparently spellbound - immediately lost any recollection of their own reservations.

In spite of "new" appearing in all titles of Krueger's papers, and the academically unusual fact that she does not quote any prior publications this approach is by no means new. Already Adam Smith advocated it, and this idea has been proposed since the early 1980s (cf. Raffer 2001), as a comprehensive survey published by the IMF (Rogoff & Zettelmeyer 2002) also documents. Krueger's first speech followed several statements in favour of sovereign insolvency made just before, first by the Secretary the US Treasury, Paul O'Neill, then by the British Chancellor of the Exchequer, Gordon Brown, and the Canadian Finance Minister, Paul Martin. Two employees of the Bank of England and the Bank of Canada, Andy Haldane and Mark Kruger (2001), proposed a standstill, arguing that sovereign debtors need the safe harbour which bankruptcy law provides in a corporate context.

The economic reason behind an orderly and fair process can be illustrated at the case of Mexico after its default in 1914. After many years of debt management by creditors debt service was finally geared to Mexico's capacity to pay. Creditors received less than 10% of face values. This result - if not a better one - would have been obtained more easily and quickly by emulating insolvency, as suggested by the US Ambassador. A quick, fair and reasonable solution would also have been in the best interest of creditors, as debt management trying to make insolvent debtors pay increases unpayable debts (Raffer 2001). The record since 1982 proves this. A speedy solution of the debt problem would have limited losses for creditors as a group.

This paper is going to discuss the merits and shortcomings of Krueger's version, contrasting it with my own Chapter 9 based model. It shows that the ideas of the US Treasury combine very well with Chapter 9 based sovereign insolvency. Apparently, John Taylor's reservations about the IMF's "statutory approach" resemble mine.

The IMF's Newly Found Love for Insolvency: Another Mission Creep?

Unlike earlier proponents Krueger uses sovereign insolvency as a means to increase the IMF's influence, and - possibly - to improve its reputation after the Asian Crisis and the Meltzer Report.

This is not yet as clear from the start. Initially Krueger (2001a, p.7) argued that adjudicating disputes among creditors, verifying claims (as proposed by Raffer 1990, p.309) and confirming the integrity of voting "are not things the Fund could do well". She contends that the outcome of the process would "remain where it should be - in the hands of the debtor and creditors." (*ibid.*, p.5) However, the Fund is to endorse the standstill "[L]ike an IMF-supported adjustment program" (*ibid.*, p.7). Apart from approving stays the Fund is also to determine sustainability, and judge the debtor's economic policies. As determining the sustainable level of debts means determining the necessary reduction of claims, very little substance would re-

main in those hands where it should be according to Krueger. In spite of lip service to a limited role of the IMF, the Fund - a creditor in its own right and an institution dominated by a creditor voting majority - would continue to be judge in its own cause. The need "to end up with an approach that creates broad debtor and creditor ownership of the process" (IMF 2002, p.3) raises suspicions. It recalls the problems of "ownership" of adjustment programmes too clearly.

Meanwhile Krueger demands the role of the arbiter for the IMF:

> "The Executive Board could not play this role - it would be hard to avoid the perception that its decisions would be guided by the IMF's interests as a creditor, or by the debtor country's membership of the Fund. We would need an independent judicial organ, insulated from the Board and from IMF staff and management."
>
> (Krueger 2002a, p.9)

Krueger (2002b, p.35) demands a "new judicial organ that would carry out these very limited functions", established by an amendment of the IMF's Articles of Agreement. It should operate "independently from the Executive Board and the Board of Governors", and:

> "The amendment would provide that the decisions of the judicial organ would not be subject to review by any of the IMF's other organs, and that, more generally, the judges appointed ... would not be subject to the interference or influence of the staff and management of the IMF."

Thus this new body is to be another organ of the IMF's, without "authority to challenge decisions made by the Executive Board regarding, inter alia, the adequacy of a members policies or the sustainability of the member's debt." (*ibid.*)

The Fund's record, including enthusiastic praise of Argentina's or Indonesia's policies virtually into the crash, does not support Krueger's (2001a, p.7) assertions of the IMF's qualities as

> "the most effective channel through which the international community can reach a judgement on the sustainability of a country's debt and of its economic policies, and whether it is doing what is necessary to get its balance of payments back into shape and to avoid future debt problems."

Suffice it to mention that the IMF started structural adjustment measures in Sub-Saharan Africa already after 1973 (Khanesa-Thasan 1981), asking rhetorically how many countries got back into shape thanks to this support. Nor does the speed with which the IMF distances itself from former "model-pupils" immediately after a crisis breaks, suddenly claiming that these previously cheered and lauded policies are totally inefficient and bad.

The IMF is allegedly necessary to implement sovereign insolvency because of so-called "vulture funds". Krueger (2001a) presented this as a reason why it would take some more years before insolvency-type mechanisms could be implemented, arguing that it would be necessary to change the laws of all countries (Krueger 2001b p.3; 2001a, p.7). Otherwise vulture funds could always pick a country where they can enforce their claims successfully. To stop creditors from "shopping around for jurisdictions" she finally argues, the Fund is needed. Neces-

sary changes should be enshrined into the IMF's Articles of Agreement, which would be easier than the "heroic task" of getting every country to amend its domestic bankruptcy law.

Her argument is flawed, although it may serve the Fund's institutional self-interest well. There is an easy solution both for presently existing and future contracts (Raffer 2002a; 2002b).

- *Presently Existing Claims:* Existing contracts can only be changed if all creditors agree. Vulture funds holding claims will certainly not do so, as this is precisely the reason why they can hold out against the debtor and all other creditors. But they are in turn also bound by existing contracts stipulating which law applies in the case of disputes. About half the loan agreements are governed by New York, almost half by British law - facts that cannot be changed without unanimous consent either. Vultures cannot shop around.

Logically this means that if the US and the UK changed their laws governing sovereign immunities by inserting one short sentence this problem would be solved for almost all cases. This sentence could. e.g., be: "Starting international insolvency procedures voids/suspends all waivers of immunity relating to this case." In the UK State Immunity Act 1978, Chapter 33, this could, e.g., be inserted in Part I. More elegant formulations than mine are, of course, welcome. The right to sue must be re-installed if insolvency procedures are not concluded successfully. If those few "exotic" places such as Frankfurt followed, whose laws are occasionally agreed on, the solution would be water-tight. Even if vultures chose to sue outside the stipulated jurisdiction its law would apply, not allowing any lawsuit in this matter. Although the rather unlikely case of existing contracts stipulating, say, Nauruan or Monaco laws - which for the sake of the argument (I have not the faintest idea about them) might allow lawsuits in such cases - cannot be excluded, this seems unlikely to be a frequent concern.

As Krueger (2001a, p.4) points out, it is not absolutely clear whether Elliott's strategy would "survive legal challenge in future cases". But in the case of Peru the threat of raising troubles was apparently great enough to make the country pay. The recent initiative by the Chancellor of the Exchequer seconding the idea of the International Institute of Finance to seek a definitive judgement in a future case are needed and welcome. If rumours are right that Gordon Brown may provide legal support to poor countries to enable them to defend themselves more vigorously in court, this would be extremely helpful for anyone but vultures.

Doubts are supported by a relevant US court case, allowing the *prima facie* assumption that a change of laws might not even be necessary. In 1984 the US Court of Appeals for the Second Circuit in New York granted Costa Rica US insolvency protection. The Court recalled a Canadian precedent, drew analogies to US laws, quoted § 901(a), stating that Costa Rica's actions were "*consistent with the law* and the policy of the United States" and

> "in entire harmony with the *spirit of bankruptcy laws* the binding force of which ... is *recognised by all civilised nations* ... Under these circumstances *the true spirit of international comity requires that schemes of this character*, legalized at home, *should be recognized in other countries*."

(UNCTAD 1986, p.142, emph. mine)

After a rehearing in 1985 the court reversed itself. The executive branch had joined litigation as *amicus curiae*, clarifying that they supported the IMF rather than principles and spirit described by the court. Therefore a simple change in the administration's policy appears to be

sufficient to allow US debtor insolvency protection to be applied to sovereigns. Recent cases declining protection to foreign governments also cited US policy. Tarullo (2001, p.676) believes it possible that a change in policy might suffice, but would not exclude that courts might decide against the US administration. To be perfectly sure this would have to be checked thoroughly by specialised lawyers familiar with these US laws, but there is reason to believe that a change of present laws would not even be necessary.

Tarullo (2001, pp.676f) also suggests that the sweeping powers pursuant to the International Economic Emergency Powers Act "appear easily to encompass the imposition of a stay". He is right to pint out, though, that the imposition of a stay by other countries would generally be necessary. At least Britain would have to join – enforcing a stay in whichever way - to allow a solution for present crises.

Secretary O'Neill's recent support of international insolvency encourages hope that the US might be prepared to reconsider past policies. As the US would have to support any scheme of international debt arbitration the difference between a change of laws by inserting one small sentence and mere support by the administration might possibly not be of great practical importance.

- *Future Contracts*: Future contracts can include any or all of the useful changes proposed so far, such as any of the clauses proposed by John Taylor, or agree on arbitration instead of waivers of immunity, as preferred by Brazil (Rocha 1999, pp.91f). The legitimate and understandable creditor interest in having legal protection and possibilities of redress against breaches of contract would be served by arbitration as well. Some contracts between countries and private creditors already stipulate arbitration. But one could also agree on a traditional waiver of immunity combined with a clause stating that no creditor is allowed to sue during international Chapter 9 proceedings. Recent contracts by Canada and the UK incorporating new clauses regarding creditor actions into debt contracts are a useful and commendable way of breaking the ice. All this would put vultures out of business.

The only question remaining is whether creditors are likely to shop around for jurisdictions where waivers of immunity are not voided by international debt arbitration, or to prefer contracts without any clauses eliminating the vulture problem. Logically, this is unlikely. At the time of lending and signing vultures will not be present. It makes little economic sense to lend money at 100, watch it fall from its nominal value to, say, 20 in order to sue then to get 100. *Bona fide* creditors have a legitimate interest in not creating trouble for themselves, including the risk of getting less because of vultures. Payments to vultures always are against the interest of *bona fide* creditors, be it because they get less than they otherwise would, because this money cannot be used to finance recovery, which would have negative effects on the debtor's future creditworthiness, or simply because of the trouble created by disruptive interference. Appropriate clauses in new contracts, including causes prohibiting lawsuits during international insolvency proceedings before a neutral panel, are thus in the interest of most creditors. While irrational behaviour can never be totally excluded, it seems not unlikely that the experience with vulture funds may make creditors prepared or even eager to avoid such problems in the future. Examples from the past such as sharing or negative pledge clauses in syndicated lending corroborate the conclusion that normal - i.e. *bona fide* - creditors have an interest in orderly and fair work outs rather than in grab races, creditors interested in long term relations with a country even more so. "Vultures" logically oppose waivers of immunity determining jurisdictions where they are overruled by starting insolvency as much as majority voting clauses. Both bar them from operating. If one believes creditors to be prepared to accept the

latter option there is little logical reason why they should fiercely oppose the former if they can be assured of as fair a protection of their rights as in all other cases of insolvency.

Reservations against an Increased Role of the Fund

Quite a few reactions against Krueger's initiative are apparently caused by concern about increasing the role of the IMF further, which is absolutely justified. The fact that the IMF has not been able to put debtors on an economically sound base again has already been mentioned. But during debt management International Financial Institutions (IFIs) including the Fund, have gained undue preference for their claims. *Emerging Markets this Week* (no. 26/1999, October 15, stress in orig) published by the German Commerzbank expressed the justified concern of private creditors very succinctly: the IMF and IBRD "will be concerned *with protecting their own balance sheets* rather than with fair 'burden sharing'". Therefore the "IMF and World Bank are not suited either as arbitrators or as objective regulators of sovereign insolvency procedures."

John Taylor (2002, p.3) rightly characterised the IMF's approach as calling "for a larger role of the IMF or the newly created agency" - which, according to Anne Krueger's present perception would again be the IMF. Many Executive Directors identified "concerns about significantly extending the Fund's powers in a statutory approach" (IMF 2002, p.3). Taylor proposes "an arbitration process for which the contracts could provide" to handle inconsistencies between "different types of issues or jurisdictions". As the clauses he proposes combine perfectly with sovereign insolvency - the representation clause for bondholders would indeed improve insolvency procedures substantially - one may arguably deduce that he is against one specific model, but not necessarily against any form of insolvency. Obviously Taylor is not against arbitral awards as such, but against centralising the process with the IMF. Private creditors do not necessarily shy away from arbitration, an instrument fairly popular except for sovereign debts, both with the International Chamber of Commerce and ICSID. What creditors rightly want and need is a fair procedure protecting their legitimate rights. However, this is also a precondition for functioning credit markets.

Institutionalising arbitration at the IMF is quite a different thing, not least due to the Fund's own involvement in the debt problem. The justified hope that there will be fewer new cases because of the stabilising effects of an insolvency procedure is a further argument against creating an institution specifically for this purpose. It is to be hoped that there will not be enough cases in the future to justify its existence. One cannot but concur with Taylor (2002, p.2) that "Ideally sovereign debt restructuring would never have to take place, because ideally countries would never get into unsustainable debt situations." Recalling that W. Wriston's view that countries cannot get insolvent and would always repay, led to lending without proper caution and the debt crisis of 1982, the existence of sovereign insolvency is likely to bring us much closer to the ideal. One might even argue that the debt crisis would not have occurred if insolvency relief had existed then.

Therefore *ad hoc* panels are preferable (Raffer 1990). They allow "tailor made" solutions for each specific case, leaving creditors and debtors more possibilities of choosing arbitrators. On solving a case an *ad hoc* panel is dissolved. As arbitration is a traditional means of international law, no treaty would be needed. Like in the case of the Paris Club the *de facto* agreement of important creditors and the debtor would suffice. No new institution is needed.

International Chapter 9 Based Arbitration

My proposal - also called Fair, Transparent Arbitration Procedure (FTAP) by many NGOs - was made to answer the legally correct point that Chapter 11 cannot be applied to sovereigns as it does not take sovereignty or governmental powers into account. Therefore I proposed in 1987 to use US Chapter 9 as the model, which solves the problem of governmental powers, and is thus applicable to sovereigns (Raffer 1989). Naturally, I never suggested to apply all the details of domestic Chapter 9, but its basic principles, which should form the basis of arbitral proceedings. Clearly, some important and necessary details of domestic Chapter 9 are unnecessary and inapplicable in the case of sovereigns. Eligibility and authorisation to be a Chapter 9 debtor - fundamental and useful as they are within the US - are one example.

The basic function of any insolvency procedure is the resolution of a conflict between two fundamental legal principles. In a situation of overindebtedness the right of creditors to interest and repayments collides with the principle recognised generally (not only in the case of loans) by all civilised legal systems that no one must be forced to fulfil contracts if that leads to inhumane distress, endangers one's life or health, or violates human dignity. Briefly put, debtors cannot be forced to starve themselves or their children to be able to pay. Although their claims are recognised as legitimate, insolvency exempts resources from being seized by *bona fide* creditors. Human rights and human dignity of debtors are given priority over inconditional repayment.

The main features of a sovereign insolvency are (see also Raffer 1990):

Arbitration: It is the very fundament of the Rule of Law that one must not be judge in one's own cause. Civilised insolvency laws applicable to all debtors except Developing Countries demand a neutral institution assuring fair settlements. Like all legal procedures insolvency must comply with the minimal demand that creditors must not decide on their own claims. Even at the time of debt prisons creditors were not allowed to do so. A neutral arbitration panel must be established to allow absolutely fair and equitable international Chapter 9 proceedings. The very essence of insolvency is an independent court, or - in the case of sovereign debtors - international arbitration. A fair and efficient decision on which part of a country's debts is unpayable can only be taken by a neutral entity, neither by creditors nor - of course - by debtors.

As is usual practice in international law each side should nominate the same number of persons, who, in turn, elect one further member to achieve an uneven number. One of the arbitrators is elected as chairperson. Such a neutral body of arbitration was, by the way, also stipulated by the London Accord, which reduced Germany's debt burden in 1953. Arguing that neutral arbitration panels must replace bankruptcy courts, I quoted Germany's case. (Raffer 1989, p.60).

Insolvent sovereigns could "file" for Chapter 9 insolvency by depositing their demand, e.g., at the UN. This should automatically trigger a stay. Only governments have a right to file. Independent arbitration panels must endorse standstills immediately on being formed, not any creditor such as the IMF. Any creditor practically exercising the right to determine whether a debtor is allowed to file - also by consenting to it in the way Krueger (2001a, p.5) suggests - would decide on its own claims. The panel has to reject the debtor's demand if it is unfounded, denying it any advantage from starting the procedure. This would leave the debtor economically no better than without filing. But its reputation and access to capital markets

would be severely tarnished in the case of a clear abuse. This is a strong disincentive. It must be feared that debtors are more likely to wait too long than to trigger procedures unjustifiedly.

The verification of claims, routine in all domestic cases, would be done by the panel. In many countries governments were forced to assume retroactively losses from private lending initially done without any government involvement. These socialisations of private losses must be declared null and void. Obviously unfounded claims should be excluded right away (cf. Raffer 1990). But long deliberations on the legal quality of claims should be avoided in favour of a speedy solution. Arbitrators would have the task of mediating between debtors and creditors, chairing and supporting negotiations by advice, providing adequate possibilities to be heard for those affected by the plan, and - if necessary - deciding. As facts would be presented by both parties and the representatives of the population in a transparent procedure, decisions are unlikely to affect substantial sums of money but rather solve deadlock situations. Agreements between debtor and creditors would need the panel's confirmation, in analogy to §943. It would have to take particular care that fairness and a minimum of human dignity of the poor is safeguarded - in analogy to the protection enjoyed by a municipality's inhabitants.

Sovereignty: §904 titled "Limitation on Jurisdiction and Powers of Court" states with outmost clarity:

> "Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with -
> (1) any of the political and governmental powers of the debtor
> (2) any of the property or revenues of the debtor; or
> (3) the debtor's use or enjoyment of any income-producing property."

The concept of sovereignty does not contain anything more than what §904 protects. The court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators depending on their mandate. A municipality cannot go into receivership. Unlike in other bankruptcy procedures, no trustee can be appointed (§926, avoiding powers, if seen as an exception, is very special and justified). §902(5) explicitly confirms: "'trustee', when used in a section that is made applicable in a case under this chapter ... means debtor". The US Trustee has no role beyond the appointment of creditor committees as any supervisory authority would be deemed "improper interference with the political and financial affairs of the municipal debtor." (Kupetz 1995, pp.566f). In plain English this means that a US municipality cannot go into receivership and its elected officials cannot be removed from office by the court. Liquidation of the debtor and change of "management" (i.e. removing politicians in charge) are not possible in the case of municipalities - nor should this be possible in the case of sovereigns. Similar guarantees are absent from Chapter 11 as firms have no sovereignty to protect. There are no similar restrictions on courts, and receivers are appointed in Chapter 11 cases. For insolvent corporations this makes sense. The composition plan can, of course, provide for interference into the political and governmental powers of the debtor. Also, the municipality may consent to interference by the court in such matters.

During the Great Depression Chapter 9 was introduced precisely to avoid prolonged and inefficient negotiations and reschedulings, to allow quick, fair, and economically efficient solutions for overindebted US municipalities. A first draft by municipalities that did not bar creditor intervention into the governmental sphere was rejected by lawmakers as unconstitutional. Creditor interventions such as those usual in Developing Countries nowadays were consid-

ered unacceptable. Only a new version containing §904 was allowed to pass. There is no reason why countries should be treated worse than US municipalities.

This formally powerful position of the debtor might make people, especially non-economists, doubt whether this procedure actually works. Some 500 cases within the US so far show it does. As the debtor needs to reach a solution to re-gain access to capital markets and to re-establish normal business relations, it must offer something that is acceptable to creditors. The composition plan should be fair, equitable, and feasible. Furthermore, to be confirmed the plan has to be reasonable and also in the best interest of creditors pursuant to §943(b),7. They must be provided the "going concern value" of their claims. A court decision further specified that a plan can only be confirmed by the court if it "embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle". Countervailing powers of creditors must not be forgotten. Creditor majorities can reject offers. Procedures to overcome a debt crisis must be fair to all sides, otherwise they would not be accepted, and rightly so.

Right to Be Heard: Pursuant to Chapter 9 the debtor's population has a right to be heard in the proceedings. This right would have to be exercised by representation in sovereign cases (Raffer 1990). Chapter 9 guarantees an appropriate form of debtor protection - a human right presently granted to anyone but the globe's poorest. US municipalities are allowed to maintain basic social services essential to the health, safety and welfare of their inhabitants. Participation is meanwhile officially part of debt management for HIPCs, where civil society is to participate in designing poverty reduction strategies. In Argentina civil society "participates" in the streets by banging pots. Formal representation seems a better way than that.

Equal Treatment of Creditors: Presently, an unfair discrimination exists between private creditors and IFIs. The Brady Initiative only called on commercial banks to take losses, while IFIs could insist adamantly on full and punctual repayment. There is no objective reason for this preferential treatment. The fact that IFIs have been granted it makes the present discussion about bailing-in the private sector - or Private Sector Involvement (PSI) (IMF 2002, p.2) - particularly obfuscating. Under various Brady schemes private creditors accepted losses, e.g. 35 percent in the case of Mexico. Reductions were quite generous but did not solve the problem as new official money immediately increased debts again. Although private creditors granted 45 percent reduction, Ecuador's first Miyazawa/Brady deal only shows as a small blip downwards in the country's debt time series. In 1999 finally, Ecuador was unable to honour its "Brady bonds", the first undeniable failure of this Initiative. If all creditors had reduced by only 30 percent commercial banks would have saved 15 percentage points and Ecuador would in all probability have been economically afloat again - a prime example of the necessity of equal treatment, also demanded by the Commerzbank publication quoted above.

There is an objective difference between these groups of lenders: commercial banks did lend aggressively but have usually not interfered with their clients' economic policy - nor did bondholders - while IFIs have strongly influenced the use of loans, exerting massive influence on debtor economies. IFIs have routinely taken economic decisions but refused to participate in the risks involved. They insist on full repayment, even if damages negligently caused by their staff occur, which have to be paid by the borrower. A high rate of IFI-failures might therefore render adjustment programmes necessary, which are administered by IFIs, just as failed programmes are likely to call for new programmes, as long as unconditional repayment to IFIs is upheld. This logical relation might be described somewhat cynically as "IFI-flops securing IFI-jobs." (Raffer 1993, p.158) This perverted incentive system is totally at odds with any market economy - with unsurprising results. Like any other creditor IFIs must carry the risk of losses. Like consultants they must be financially responsible for their advice. The

connection between decisions and risks is the most basic condition for the functioning of the market mechanism. If this link is severed market efficiency is severely disturbed, as former Communist economies prove. Economic efficiency, but also fairness to the debtor and to other creditors demands that IFIs should no longer be treated in a preferential way.

Statutes of multilaterals even foresee default. Article IV.6 of the IBRD's Articles of Agreement demands a special reserve covering "Methods of Meeting Liabilities of the Bank in Case of Defaults" (Art.IV.7). As the Bank's business is restricted to members (Article III.4) it follows that sovereign default is considered possible, maybe even an occasionally needed solution. Unaware of any preferred creditor status, a legal concept which cannot be found in its Articles of Agreement, its founders wanted the IBRD subject to market discipline, not totally exempt from it. Mechanisms allowing the Bank to shoulder risks appropriately were designed, and debtors have financed them. Thwarting its founders' intentions the IBRD has refused to use these reserves, wrongly claiming this would make development finance inoperational. The IBRD's very statute proves that financial accountability is necessary and possible. The European Bank for Reconstruction and Development (EBRD) writes off losses, and submits to arbitration (also foreseen for the IBRD), proving that Multilateral Development Banks can survive financial accountability and market risk.

As conditionality was initially not foreseen for IMF drawings, loan loss provisions were unnecessary. When conditionality was introduced, no appropriate changes regarding financial accountability of the Fund were made. This became particularly problematic once the IMF started massive debt management operations. Introducing financial accountability for its own decisions is thus all the more important. Equal treatment in an insolvency is one way to do so.

Generally, all creditors of one sovereign debtor - including domestic creditors - should be treated strictly equally. One possible exception may be other Developing Countries. It would not make sense to bankrupt country A by relieving country B. In such cases preferential and differential treatment, strictly according to objective criteria, such as claims affected, the creditor's GDP/head or export income, seems worth considering. Regarding some types of domestic debts exceptions should be discussed, e.g., for pensions funds forced by law to buy government bonds.

Protecting the Poor: The principle of debtor protection demands that - in analogy to the protection granted to the population of an indebted municipality by domestic Chapter 9 - the money to service a country's debts must not be raised by destroying the debtors economic future or basic social services. It is mandatory that schemes to protect a minimum standard of living be part and parcel of every international composition plan. Subsidies and transfers necessary to guarantee humane minimum standards to the poor must be maintained. Funds necessary for sustainable economic recovery (a "fresh start") must be set aside.

This exemption can only be justified if that money is demonstrably used for its declared purpose. Not without reason creditors as well as NGOs are concerned that this might not be the case. Protecting the poor can be done by targeting social expenditures on those needing support. Considerable knowledge how to do so exists (Raffer 1990, pp.305f). Present anti-poverty strategies under HIPC II meanwhile also demand protection of the poor. Good results can be achieved with limited financial resources. These resources, however, must be exempt from debt service.

The solution is quite simple - a transparently managed fund financed by the debtor in domestic currency. In a discussion with public servants of the G7 and representatives of the Bretton

Woods Twins Ann Pettifor (1999) proposed a Poverty Action Fund as a means to guarantee that resources are actually used for the poor and for expenditures necessary for a fresh start of the debtor economy. The management of such a fund could be monitored by an international board or advisory council consisting of members from the debtor as well as from creditor countries. They could be nominated by NGOs and governments (including the debtor government), and private creditors should they wish to do so. As this fund is a legal entity of its own, checks and discussions of its projects would not concern the government's budget, which is an important part of a country's sovereignty. Aid could also be channelled through the fund, changing its character of money just set apart from the ordinary budget towards a normal fund for the poor.

As all creditors of the debtor are to be treated equally, domestic institutions such as pension funds can be strongly affected. The plan could - if necessary - foresee a project of securing pensions. In other words, the state is left with money to repay a certain sum (not necessarily the whole sum lost) to people having lost (part of) their pensions, guaranteeing a decent standard of living. As payments would not be due immediately (except for those about to retire) the financial burden would not be felt during or immediately after the crisis, but after recovery. In countries where pension funds were - unlike other creditors - required by law to buy government bonds, guaranteeing a minimum pension seems but fair.

Regulatory Changes: Although not a necessary part of an international Chapter 9, this could also be used as an opportunity to introduce stabilising regulatory changes into the international financial architecture. National laws and regulations creating unnecessary complications and "legal risks" to creditors could be changed. The economic function of loan loss provisioning could be reconsidered. Whether to have a tax system that encourages more prudential provisioning is, of course, a political decision. It can, however, be shown that the costs of tax deductible loan loss reserves to taxpayers have always been strongly exaggerated. Under the assumption of a sufficiently well functioning regulatory framework only no or negligibly small costs to the budget are possible, which might be outweighed by greater stability due to the important stabilising function of loan loss reserves. Adopting the principle of tax deductibility prevalent on the European continent could therefore increase the stability of international financial markets (for details see Raffer 2001). Continental Illinois or the case of the US S&L institutions may suffice to show that extremely limited tax deductibility does not necessarily mean no costs to the taxpayer.

Main Differences between the Models of Krueger and Raffer

Some main differences between an international Chapter 9 and Krueger's approach should be pointed out:

- *Which Form of Insolvency*: Initially, Krueger did not refer to any Chapter, but is was soon clarified that she thought of Chapter 11 rather than Chapter 9. She still does not draw any final conclusions on which Chapter should be used as the model, meanwhile seeing, however, Chapter 9 as "of greater relevance", concluding: "All these features could be appropriately integrated into a sovereign debt restructuring mechanism" (Krueger 2002b, p.12f) - which repeats the conclusion of Raffer (1990). Her point that a municipality is not independent - in the sense of a sovereign - is right. But one might discuss whether this is "one of the reasons why many countries have not adopted insolvency legislation to address problems of financial distress confronted by local governments." She points out that Chapter 9 legislation does not im-

pair "the power of the state within which the municipality exists to continue to control the exercise of the powers of the municipality, including expenditures."

In fact, §903 reads:

> "This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but -
> 1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
> (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition."

In other words: although state legislation is restricted as regards insolvency (cf. Kupetz 1995, pp.581ff), municipalities are basically subject to state and federal laws - but so are corporations. Naturally, the necessity of delimiting federal from State rights, and of safeguarding constitutional rights of States exists in domestic cases. But it is difficult to see any possible relevance of these norms for sovereigns. This is an example of inapplicable detail. It does not make the basic principles of Chapter 9 less relevant.

- *Equality of Creditors*: One must fully and literally concur with Krueger (2001a, p.6) that no creditors should be treated more favourably than others. Unfortunately, she does not mean it literally, demanding that the IMF's claims remain exempt, that its de facto preference be finally legalised. This undue preference of IFIs means that all other creditors get less. All kinds of debts must be included.

- *Role of IMF*: My proposal would not increase the power of the IMF, thus accommodating the strong reservations of some creditors. The Fund would become one of the creditors, no longer enjoying undue preferences, costly to other creditors and the debtor. The Fund's rights as a creditor of presently existing claims would guarantee it full participation in the proceedings, but no role as a debt manager, only as one of the creditors. The Fund could offer technical help in solving problems or help co-ordinate bondholders. The IMF could encourage countries to go down the road indicated by the Fund now. After opposing this very mechanism for decades this would be helpful in avoiding further damage.

The IMF could lend money necessary to keep the country afloat during the procedure, but only without any conditionality attached, as initially foreseen at Bretton Woods. This money would serve a useful role, which - if it need be - could be seen as providing a public good, as Krueger does. It could be interpreted adapting the IMF's initially agreed on function to the present world economy. These - and only these – fresh loans must enjoy seniority, or "some kind of preferred creditor status" (Krueger 2001a, p.6). In contrast to present multilateral debts, there is an objective reason and a necessity for preference - as in all domestic insolvency laws. Such preference would, of course, also be enjoyed by other creditors prepared to inject "new" money at this stage for the same reason. However, new money must not be given to "finance payment to priority creditors" (Krueger 2002b, p.17) - i.e. to bail out the Fund or other IFIs.

- *Institutionalisation*: Favouring quick implementation and hoping that new cases will be rare I propose no institutionalisation, and no new bureaucracies. *Ad hoc* Chapter 9 arbitration should be used for all insolvent countries, including HIPCs.

- *Speed of Implementation*: Krueger wrongly states that it would take years to implement insolvency to argue that present cases cannot be dealt with. The examples of Germany's debt reduction in 1953, Indonesia's after 1969, or Poland's after the demise of communism disprove this opinion. Any further delay would impose those unnecessary costs Krueger rightly deplores. Arbitration is a traditional means of international law, highly popular at present in all cases except when it comes to protect the poorest in indebted countries. *Ad hoc* panels could be formed immediately if important official creditors agree. Present cases such as Argentina should already benefit from meaningful debt reduction. This argument of hers does not justify further delays. On the contrary, to limit unnecessary sufferings the solution has thus to be implemented at once, i.e. already in the case of Argentina.

- *Rule of Law, Fairness, Debtor Protection, Right to be Heard, Transparency*: All these features are absent in Krueger's variant.

Concluding Remarks

The Ministers and Governors of the Group of Ten (2002) "re-affirmed the principle that debt contracts should be honoured on time and in full. Nevertheless, circumstances may arise where this may not be possible." This puts the essence of sovereign insolvency nicely into a nutshell. Like an emergency brake sovereign insolvency is useful in emergencies. It is not the routine way of stopping, but people are happy to have it if and when needed. They are certainly even happier if they do not need it. A useful and necessary part of a sound international financial architecture, sovereign insolvency should be seen in the same way.

The present discussion fuels hopes that Adam Smith's lucid advice will finally be heeded after decades of unsuccessful "debt management", that unfair discrimination of one type of debtors is about to end, and the Rule of Law as well as the human right of debtor protection will finally no longer be a privilege of people in the North. It is to be hoped with Anne Krueger that no further delays will occur, imposing unnecessary costs on debtors and the international community. One seems entitled to hope that a child's life expectancy will eventually depend a bit less on whether (s)he is born in a heavily indebted municipality within an OECD-country or in a heavily indebted country in the South.

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