Kunibert Raffer

Schemes for Resolving the Sovereign External Debt Problem

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Removing crushing debts is the precondition for any successful development policy. Various debt reduction schemes dictated by creditors have not achieved it. The evolution of overindebtedness and the effects of insufficient reductions are illustrated numerically to show shortcomings of debt management. Efficient historical examples, particularly Germany 1953 or Egypt 1876, prove that solutions were more efficient and debtor-friendly before BWI-led debt management. Absolutely dominating creditors have granted too little too late, causing damages to debtor economies remaining either overindebted or with high debts facilitating further crises. The necessity and feasibility of a Fair Transparent Arbitration Process (FTAP) modelled after domestic insolvency for debtors with governmental powers (US Chapter 9), and its immediate applicability to sovereigns are shown. Its essence is the very fundament of the Rule of Law: impartiality (not being judge in one's own cause), and debtor protection. Civilised legal systems do not allow forcing debtors to starve their children to pay more. Except for Developing Countries this human right overrides the sanctity of contracts. Arbitration based on these principles provides an economically efficient and humane solution. The Rule of Law and this basic human right must no longer be denied to any human being. Arbitration must replace arbitrariness.

It is clear that sovereign debtors are unable to repay fully. Eventually offering various debt reduction schemes creditors recognised this long ago. Nevertheless, the problem has dragged on, obstructing development. Insufficient reductions have burdened debtor economies. This is evident for HIPCs. The first HIPC Initiative's officially declared objective was reaching overall debt sustainability by co-ordinated action, allowing countries to exit from continuous rescheduling (IBRD 1997, p.44). The very existence of HIPC II proves that HIPC I was unable to do so. James Wolfensohn's efforts are laudable. A welcome step into the right direction HIPC I did not go far enough, which is also a shortcoming of HIPC II. The problem is possibly less visible in the case of Middle-Income Countries, where high debt stocks remain the underlying cause of crises that would not occur if debt reductions had been sufficient.

This paper starts with a simple illustration of evolution and effects of overindebtedness. Then historical examples are compared with present strategies. Finally, the idea of a Fair Transparent Arbitration Process (FTAP) on debts is discussed – a “debt arbitration process to balance the interests of creditors and sovereign debtors and introduce greater discipline into their relations" (Annan 2000, p.38).

The Nature of a Debt Overhang

Overindebtedness – often called debt overhang in literature - describes a situation where parts of the debt stock are unapayable. This can be shown by a simple numerical illustration: 5% interest, no amortisation, and $1000 debt stock initially. The example could be complicated, e.g., by introducing amortisations, variable interest rates or inflation. This would make it less clear, but leave the basic mechanism unchanged. Capitalised arrears increase debt stocks, as anyone familiar with basic mathematics can verify.

During year 1 debts grew by capitalised arrears of $25. As the debtor is insolvent not (temporarily) illiquid this problem does not disappear. Debts accumulate. At the end of year 10 the debt stock is $1279 ($1247 + $32). The gaps between debt service due and actually paid widen although debt service increases steadily, possibly so because of the lemon squeezer effect of BWI-type "Structural Adjustment". Debts accumulate in the books of creditors with increasing shares of what may be called "phantom debts". These exist on paper but are economically unreal as they cannot be cashed, they are technically irrecoverable.

Table 1: The Evolution of Unpayable Debts

	Debt Stock	**Debt Service Due**	**Debt Service Paid**	**New Debt**
Year 1	**1000**	**50**	**25**	**25**
Year 2	**1025**	**51.25**	**26.25**	**25**
Year 3	**1050**	**52.5**	**26.5**	**26**
Year 4	**1076**	**53.8**	**27.8**	**26**
Year 5	**1102**	**55.1**	**28.1**	**27**
Year 6	**1129**	**56.45**	**28.45**	**28**
Year 7	**1157**	**57.85**	**28.85**	**29**
Year 8	**1186**	**59.3**	**29.3**	**30**
Year 9	**1216**	**60.8**	**29.8**	**31**
Year 10	**1247**	**62.35**	**30.35**	**32**

Caused by creditors unwilling to grant needed reduction in time, debts are boosted to ever more unrealistic levels. Debt reduction to sustainable levels appears costlier and costlier on paper. Cancelling $520 after two years would have allowed the debtor to pay as due - if the income level (foreign exchange earnings for sovereigns) assumed for this year can at least be

maintained. This is by no means sure if protracted debt service at the cost of necessary replacements has reduced long run production capacities, as feared by the IBRD or the GATT already in the 1980s. Finally, $672 must be cancelled (new stock: $607) to allow honouring all obligations with $30.35. The difference ($152) – pure phantom debts created by arrears accumulating on top of already unpayable debts - results from creditors' opposition to timely reduction.

From this simple illustration interesting conclusions emerge:

1) Deleting phantom debts simply acknowledges facts. As one cannot lose money one cannot get, this costs creditors not one cent. It is "generosity for free". Debtors get no real relief. Costs of debt relief are exaggerated by including phantom costs at face value. An example are costs of $34 billion over time – two thirds of HIPC's total costs - estimated officially for 22 Decision Point HIPCs.

2) Meaningful reduction must go beyond removing phantom debts. A certain share of remaining claims can be paid if the debtor's future - in US legal parlance: "fresh start" - is put at risk. In any insolvency case more than $152 would be cancelled to protect debtors and to ensure economic sustainability. Investment needed to ensure viability and "tools of trade" are exempt. Debtors are also guaranteed a minimum standard of living. Too small reductions – Highly Insufficient Payments Cuts (HIPCs) - expose debtors to relatively small external shocks and are likely to impair their capacity to honour remaining obligations. Rational private investors will be reluctant to invest, fearing the next "Adjustment" programme. Nationals have an incentive to transfer assets out of their country. It cannot be excluded that high real interest rates may attract highly speculative, extremely short term capital hoping for a quick buck made within a (few) day(s) before leaving again, particularly so if speculators expect being protected by official bail-outs socialising losses. But such inflows are a far cry from capital needed to finance development, and likely to aggravate rather than to defuse crises.

3) Too small or just sufficient reductions conditioned on additional expenditures by debtors logically produce new crises as lending is needed to finance debt relief. The interest rate of additional borrowing is immaterial. Even 0.5% is unfeasible. If $160 are cancelled ($8 more than those $152 called pure phantom debts) conditional upon the debtor's financing measures (e.g. poverty reduction) amounting to $16, the debtor has to finance these

programmes by new loans. New arrears accumulate, even without external shocks. An increase of 8 cents per annum ($16 at 0.5% interest) is moderate. The arbitrarily assumed 10% swap for poverty reduction is low. But circular causation of arrears starts again, evolving relatively slowly due to the high concessionality of additional borrowing. Demanding softer IDA-terms (99 years maturity, 40 years grace) the Zedillo Report (p.61) was possibly aware of this problem.

Poverty reduction and investments necessary for sustainability must be financed from debt reductions beyond $672 – from money creditors could technically collect without debtor protection. Additional financing must obey the restriction

$$\text{Additional Financing} \leq (\text{Total Reduction}) - 672 \qquad (1)$$

If equality signs apply debtors remain exposed to minimal shocks and the risk of being unable to maintain perceptibly increased payments ($30.35). Insufficient cancellations create vulnerability. If HIPCs pay more after "relief" than before other expenditures are crowded out by increased debt service.

4) Delaying relief creditors caused damages to debtors, and made things more difficult for themselves. Substantial shares of present debts were caused by creditors delaying necessary reductions over years. The IBRD (1997, p.42) acknowledged:

> The surge in borrowing, coupled with increasing reliance on rescheduling and refinancing, increased the nominal stock of debts of HIPCs from $55 billion in 1980 to $183 billion in 1990 ... by the end of 1995 it had reached $215 billion.

In 1990-5 growth reflects shifts towards grants, higher concessionality, and debt cancellations. UNCTAD (1998, p.127) estimated two thirds of the increase in Sub-Saharan African debt since 1989 to be caused by arrears. Such increases and their effects are creditor caused damage. The IBRD (1992, pp.10ff stress in original) stated:

> *In a solvency crisis, early recognition of solvency as the root cause and the need for a final settlement are important for minimizing the damage ...* protracted renegotiations and uncertainty damaged economic activity in debtor countries for several years ... It took too long to recognize that liquidity was the visible tip of the problem, but not its root.

Two IBRD-economists, Ahmed and Summers (1992) quantified the costs of delaying recognition of the "now" generally acknowledged solvency crisis as "one decade" lost in development. The Bank failed to mention that creditors (including the IBRD itself) prevented acknowledgement. At the US Treasury Summers corroborated his opinion (*Time* 24 July 2000, p.45): "Even the toughest private lenders write off their bad debts. That's what governments - and private lenders - need to do with bad loans they have made." Neither the IBRD nor the US have acted accordingly so far. Paul O'Neill's, the present Treasury Secretary's, statement in favour of establishing an international bankruptcy law allowing countries with excessive debt burdens to work out debt reduction agreements with foreign creditors instead of depending on IMF bailouts is encouraging, though.

5) Assuming exports earnings of $600 conventional debt indicators based on actual payments are 5.06% - Debt Service Ratios (DSR = debt service divided by export earnings) are also Interest Service Ratios (interest payments/export earnings) in our example. They hide accumulating arrears. The less countries pay - the higher a debt overhang grows - the lower DSRs become. If debt service actually due were divided by export revenues (DSR_d^*) 10.4% would result, more than double the conventional ratio, which is equally low for countries without debts and heavily indebted countries not paying at all. Therefore Raffer (1996) recommended dividing actual debt service by contractually due debt service as a suitable indicator for overindebtedness:

$$0 \leq DSR/DSR_d^* \leq 1 \quad (2)$$

This indicator is 1 if all payments are made on time, zero if the debtor does not pay at all. In our illustration this unambiguous indicator, obviously useful to assess the capacity to pay, is 0.487. Less than half of debt service due is actually paid. Compared with actual figures this is not unduly low. Calculating DSR_d^* with readily available IBRD-data for Sub-Saharan Africa and Low-Income Countries during the 1990s produces values around 0.2 and 0.4 respectively. In 1992 Sub-Sahara Africa's $DSR_d^*$was 0.126 (Raffer 2001): the region paid roughly one eighth of its contractual obligations. The situation improved after 1992 as even insufficient debt relief is better than none. But the crisis has continued.

In the early 1990s, when official creditors declared the debt crisis over, Latin America paid less than half its debt service due. Deducting Mexico, Chile, and Uruguay (countries without arrears according to official statistics) my index was 0.3497 in 1992, the last year for which

the IBRD had published data (not projections) by September 1994 when Raffer (1996) was presented as a conference paper at Lancaster. Brazil honoured one third of its contractual obligations, Argentina about a quarter. It could also be shown that Miyazawa-Brady type reductions were insufficient. Only in the case of Costa Rica a clear positive impact was observed, even though arrears continued. However, warnings or drawing attention to balance of payments evolutions, especially in Mexico, were unwelcome during the euphoria before the Tequila Crisis.

Lessons from History

Generally, sovereign debtors including “Developing Countries” were treated much more generously in the past (cf. Acosta 2001) before the BWIs became debt managers. The final outcome of Latin American’s debt crisis in the 1930s may be seen as de facto insolvency. After negotiations Brazil’s debts were reduced by over 75% in 1943. “Debt default eased payments constraints” (Maddison 1985, p.28) in Chile. Colombian local governments (municipalities, possibly) pioneered debt default, central authorities followed later. Some big European debtors were themselves delinquent regarding their debts after World War I. The British and French governments defaulted in the 1930s, considering their peoples’ needs more important than legal obligations to creditors. The essence of this argument is familiar to insolvency specialists. In the 1940s nine US states suspended interest payments on loans when the price of their main export good, cotton, left them short of foreign exchange. US states – sovereign with regard to debts - have a long record of defaulting. The term repudiation was apparently coined by Mississippi simply refusing to honour its debts in the 19th century.

In 1876 the representatives of private bondholders decided to use Egyptian insolvency law as the yardstick to solve Egypt’s debt crisis. How this debt accumulated is not discussed here, nor its role in Anglo-Egyptian relations, only the technicalities of the solution. The administrator appointed to protect creditor interest, Evelyn Baring, did not apply the "lemon squeezer" approach of today’s BWIs. He lowered, e.g., taxes, postal fees, financed expenditures in public health and education, encouraged improvements in irrigation. Wages and pensions were paid out in full. After surprisingly few years he was economically successful for creditors and the debtor alike (Dommen 1999). A hard nosed 19th century capitalists managed this crisis much better and more quickly than international public sector institutions nowadays.

After Mexico’s default of 1914 the US Ambassador proposed following Egypt’s example, but did not prevail. After years of debt management debt service was finally geared to Mexico’s capacity to pay. Creditors received less than 10% of face values. The Egyptian solution would most probably have delivered this outcome more quickly and more cheaply for anyone involved.

Two spectacular cases of *de facto* composition occurred after 1945: Germany’s London Accord and Indonesia’s reduction 1969. Both roughly halved the present values of debts.

Comparing Germany’s debt indicators with those considered "generous" under HIPC II shows a technically inexplicable difference between debtors. Germany’s DSR before debt reduction was below 4%. Unlike 15% for HIPC II this was considered unsustainable. No doubt Germany's reparations after World War I, which the country had to pay against Keynes's advice, were one important reason why Germany's debt burden - relatively much lower than the burden of many Developing Countries - was seen as unbearable for a sovereign debtor in the 1950s, stifling Germany's economy. But if the German economy is objectively stifled - why should an even larger burden be sustainable for poorer countries? Table 2 reproduces Germany’s debt indicators as calculated nowadays.

Table 2: Germany’s Debt Indicators 1949-53
(% of export earnings)

Year	Debt Ratio[a)]	DSR[b)]
1949	358	13.71
1950	173	6.78
1951	99	3.89
1952	85	3.35
Jan-Jul 1953	90	3.52

[a)] Debt Stock/Exports
[b)] Debt Service/Exports

Source: Hersel 1998

Scheduled DSR fell from 3.06 (1953) to 1.84 (1956), only once exceeding 2% slightly after 1956 (1958: 2.07) when amortisation started after five years grace. Germany's economy boomed so dynamically that the country outdid its schedule, using contractual possibilities of early repayments. Still, it always paid less than 5% of export earnings, never more than 60% of its trade surplus. Therefore the German Jubilee campaign *Erlaszjahr 2000* demanded an

upper debt service limit of 5%. Hersel points out that creditors accepted a German trade surplus, agreeing that debt service cannot generally exceed this surplus. Hersel (1998, p.22) concluded: "if the West Germany of 1952 were analysed under the current conditions of the HIPC-Initiative, it would not be eligible for any debt reduction". Germany was not forced to adopt “Structural Adjustment” programmes, but could pursue the very opposite, successful economic policies characterised by the term “social market economy” (*Soziale Marktwirtschaft*). These policies triggered the German "Economic Miracle" (*Wirtschaftswunder*). Neither IBRD nor IMF estimated Germany’s capacity to pay, but a German national, Hermann J. Abs, was asked to tell creditors how much they should cancel.

Abs was also the mastermind behind Indonesia’s debt reduction in the 1960s, which resembled Germany’s. Both creditors and the debtor accepted him in this role. Although his proposals were mostly followed, he did not formally have an arbitrator’s decision power. One may thus speak of a successful example of mediation, even though it was always clear that both parties were willing to implement his advice, a feature not usual with mediators in general. While Indonesia held mostly public debts, the composition also covered private claims. Abs (1969, p.9) insisted on strictly equal treatment of all creditors as "indispensable for any settlement of debts". Since Indonesia had substantial debts to Communist governments, this demand was also politically important.

As creditors refused to recognise Indonesia as a precedent Abs (1968) had to find special reasons why this solution was singular, and inapplicable to other debtors. These were:

- *All old debts were contracted by the previous government.*
- Indonesia's debts consisted predominantly of *credits with little or no economic usefulness*; practically the whole debt service had to be financed by the central budget.
- High inflation could only be brought under control by energetic policy and *exceptionally generous help from without*.
- *The country was unable to repay its debts in the future*.

Indonesia's debtors, especially the Paris Club, obviously recognised these reasons. In present specific cases where they apply logic would thus suggest this solution - without creating legal precedents if necessary. When Ghana demanded "Indonesian type" relief a bit later, creditors were reluctant to grant comparable terms, explaining this by the desire to avoid precedents. Eventually, Ghana was granted very "generous" terms (Hutchful 1987, pp.273f) that have remained undisclosed until this day. After timid attempts to propose Indonesia as a model

during the 1980s, the IBRD tries to create the impression nowadays that Indonesia did not get debt reduction.

More recently Poland, and Egypt received substantial debt reductions. Politically motivated they show nevertheless how quick and simple debt reductions can be when creditors agree.

Present Strategies

Debt management (for its evolution cf. Raffer & Singer 2001, pp.158ff) was initially based on the "illiquidity" theory. Countries would grow out of debts, there was no need for reduction (Venice Terms, "Baker Plan"). As in our numerical illustration long term debt of all Developing Countries roughly doubled from $546.9 billion to $1,114.9 billion (compound growth rate: around 10% p.a.) between 1982 and 1989, when the US decided debt reduction was necessary.

Recognising the necessity of reducing debts for Middle-Income Countries (Miyazawa/Brady) and at about the same time for poor countries (Toronto Terms) were positive changes. Addressing only private creditors Miyazawa/Brady remained insufficient for sustainable viability. The shift of the composition of debts after 1982 towards higher shares of official creditors reduced the probability of success further. Substituting commercial bank claims by multilateral money to be served at any costs to get the "seal of approval" was problematic. While "Brady Deals" did demonstrably not restore economic viability in any "Brady country", Ecuador's formal default on its "Brady bonds" in 1999 was a clear and undeniable proof of failure - Ecuador's sustainability had not been re-established. Although commercial banks granted 45%, which is quite generous, Ecuador's debt time series shows only a very small blip downwards as new official money increased debts again. In contrast to new loans after the debtor's successful fresh start - useful and needed for profitable projects - such new debts during an unresolved crisis reduce the effect of debt reductions, preventing the country from getting a fresh start. If all creditors had reduced by 30% commercial banks would have saved 15 percentage points, and Ecuador would in all probability have regained sustainability. But this would have needed a comprehensive approach with equal treatment of all creditors. Debt reductions by only one group of creditors are likely to be insufficient. As the present situation of Latin American debtors proves neither Brady nor the debt reduction option under the *Enterprise for the Americas* initiative could restore sustainable financial stability.

After the Asian crash corporate insolvency procedures are seen as essential for avoiding future crises. The Reports on the International Financial Architecture recommend it strongly, avoiding insolvency with regard to sovereigns, though. The Working Group on International Financial Crises proposed an insolvency procedure in all but name, demanding the international community to provide: "in exceptional and extreme circumstances ... a sovereign debtor with legal 'breathing space' so as to facilitate an orderly, co-operative and negotiated restructuring" (OECD ed. 1998, p.37).

Emulating insolvency features, such as debt reduction by qualified creditor majority or "Collective Action Clauses" for sovereign bond contracts, was recommended as a critical contribution to "creating the institutional structure needed to encourage orderly workouts" (*ibid*., p.21), because a "binding insolvency regime for sovereign debtors is unlikely" (*ibid*., p.19). Such clauses, though, would only be helpful for future crises. The Report even admits that "a purely voluntary approach" might not be feasible because "the government may not have the bargaining power to obtain sustainable terms" (*ibid.*, p.30), e.g. if creditors demand destabilisingly high interest rates. It remains to be asked why one shied away from the obvious conclusion - the need of an independent entity empowered to decide - and why all the advantages praised in the case of firms should not be advantageous in the case of sovereign debtors. The fact that bonds are a quite common instrument in the case of municipalities underlines that Chapter 9 can easily bail-in this new form of sovereign debt.

Constructive default as proposed by Adam Lerrick and Allan Meltzer in the *Financial Times* (10 May 2000) is a viable alternative to bail-outs. It removes moral hazard by private creditors, which – given the harshness of IMF-conditionality – is a bigger problem than debtor's moral hazard. The moratorium (though only on payments to private creditors) is a useful feature known from insolvency. Buying at the guaranteed floor price and cancelling written-down claims to the country repaying the IMF, the Fund would be a facilitator. If the authors are right that few investors would exercise the option, the IMF would largely be a catalyst and drawings small.

While a definite improvement over present strategies this proposal may be problematic:
- if debts are purely private debts losses are socialised ("Asian Case"), increasing sovereign debts

- if the country's economic policies (except liberalising capital accounts) did not cause the crisis it may have to apply unnecessary, even harmful IMF remedies
- like with Miyazawa/Brady only one group of creditors is affected. This is unfair and moral hazard of others persists. Writing down private claims only may either be insufficient or losses may have to be quite large to reach sustainability, thus triggering higher risk premia in the future.
- as the IMF alone sets floor prices, the risk of error is higher than if losses are determined by open fair procedures. The Fund might set floor prices with its own lending unduly in mind.

Without institutionalised relief shifting private debts onto governments remains unduly attractive. Retroactive public "guarantees" had to be granted in Latin America, increasing sovereign debt overhang – mostly not by sovereigns' free choice. Purely private risk was largely socialised during the Asian Crisis, landing governments with enviable economic records suddenly in trouble. Possibly because of 1997 the High-Level Regional Consultative Meeting on Financing for Development, Asia and Pacific Region (Jakarta, August 2000) saw "a need for an international bankruptcy procedure. It should be ensured that private debt does not become government debt."

In parenthesis one might mention that exercising IMF-membership rights to capital controls on all but current transactions would at the very least have softened the impact on Asian countries considerably. It remains to be asked why the IMF has violated its own constitution by keeping members from exercising their rights. Capital controls temporarily barring outflows are equivalent to unilaterally imposed standstills. As a rule standstills are economically sensible to allow proper work-outs. The analogy is an automatic stay of enforcements of claims against debtors having filed insolvency. Without automatic triggering rules or an institution demanding the debtor to do so, however, an economically indicated technical decision risks being misinterpreted as an unfriendly act, even though creditors might understand the technical necessity. Giving the IMF authority to impose standstills is problematic, as it is both a creditor in its own right and dominated by creditor majority. A stay triggered by FTAP is better.

Ecuador illustrates the shortcomings of Paris Club procedures as well. Between July 1983 and September 2000 it was seven times at the Paris Club – nearly every other year on average (precisely 0.4 times/year) - which hardly suggests efficient and sustainable solutions. Too little is given too late. Economically this does not make sense, as phantom debts remain

unpayable. If only their growth is curbed – which in itself is positive – the base for the next crisis is provided. On the other hand creditor domination has resulted in considerable political leverage of official creditors. Political scientists might call this the main difference between the Paris and London Clubs. Bankers are used to calculating in strictly economic terms. When the costs of (re)negotiations - which commercial banks have to pay and earn themselves under market conditions - start to exceed expected payments, they are more open to a fair solution. Bankers, such as D. Suratgar or Alfred Herrhausen, were quite vocal, demanding negotiated debt reductions. *Emerging Markets this Week* (no. 26, October 15, 1999) published by the German Commerzbank wrote that private creditors would not object to "sovereign insolvency procedures ... in cases of extreme borrower distress" if all creditors share losses equally. Involving the private sector thus seems easier than bailing-in public, especially multilateral, creditors. Presently, the two Clubs serve the short term purpose of defusing immediate crises, often causing future crises, though. In both cases there are no rules governing procedures, nor any independent entity to guarantee fairness. Debtors are totally at the mercy of creditors.

Changes from Venice to Cologne Terms also recognise the insufficiency of pre-Cologne measures, and the ineffectiveness of "Structural Adjustment" unable to solve the problem over decades. The economic sense behind a Cologne debt service option achieving reduction "through concessional interest rates and a repayment period of 125 years, including 65 years of grace" (IBRD 2000, p.171) remains unclear at best. The "'bullet' option" with an interest rate of 0.0001% (the IBRD does nor dare mention maturity) would be ridiculed in the case of all other debtor-creditor relations. Politically, though, such solutions provide long term leverage over debtor countries.

The high percentages of debt relief quoted by the Paris Club are misleading, making insufficient debt relief look "generous". As only debts before the so-called "cut-off date" are "eligible", their percentage decreases as new debts - including new capitalised arrears because of insufficient reductions - accumulate. Eventually, 100% "debt forgiveness" (of eligible debts) may thus mean reductions of less than 1% of total debts. Mathematicians might joke about actual debt reduction converging to zero, while percentages "forgiven" converge to 100 - in plain English: a situation of 100% Paris Club "debt relief" without a single cent actually cancelled.

Errors producing insufficient debt relief initially are transmitted, compromising viable solutions in the future. Applying the NPV-concept to debts is also highly misleading, the higher the discount rate the more so. Discounting future debt service payments with non-concessional interest rates reduces debt burdens considerably on paper. It frontloads solutions. It is easier to reach a given NPV-reduction with reductions for the immediate future, which might cause problems later on. Discounting debts at market interest rates simply states that if debtors could invest NPVs today at the discount rate, all debts would be covered - logically true but unhelpful. HIPCs qualify as such precisely because they do not have spare money for such investments. Usually they are even unable to honour all financial commitments at concessional terms which are already too tough for them. Finally, HIPC-thresholds of "sustainability" were arbitrarily chosen, possibly so to keep nominal costs to creditors down. Countries may either pay as much after debt relief as before or even more. Debtors that would qualify by objective indicators (Indonesia, Nigeria) are excluded arbitrarily – which accommodates short-term and shortsighted creditor interests of "keeping down" nominal costs.

Paris Club decisions are unfair to debtors and non-member creditors. Demanding that the debtor seek similar treatment from other creditors shifts the burden onto the weakest. Although non-members are not represented the Club's decisions affect their claims. Relative to their economic situation (measured, e.g., by GDP/head) the burden might well be much larger. Gunther (2001) proposed to adjust burden sharing accordingly, quoting the examples of Costa Rica incurring higher costs (in dollar terms) than the US or of several Developing Countries having to pay on a per caput base a multiple of any Paris Club member under present rules. Having to implement Paris Club HIPC-relief may endanger another Developing Country's sustainability.

Well founded doubts exist already, whether HIPC II will deliver the goal of re-establishing debtors to sustainability. Suffice it to quote the US General Accounting Office (GAO 2000) assessing HIPC II on congressional request. Debt sustainability depends on annual growth rates above 6% in US dollar terms over 20 years - in four cases including Nicaragua and Uganda even above 9.1%. Understandably, the GAO doubts whether such rates can actually be maintained for that long, warning also about the volatility of commodity prices. It points out that additional money will be necessary. Like so many creditor initiatives before, HIPC II is apparently again built on fragile, optimistic assumptions and forecasts. With good reason

the Zedillo Report states that HIPC II has “in most cases” (p.21) not gone far enough to reach sustainable debt levels, suggesting a “re-enhanced” HIPC III (p.54).

The Feasibility of FTAP

FTAP has its roots in the proposal to apply corporate insolvency (in the US: Chapter 11, Title 11) to sovereigns, made quickly after August 1982 by the banker David Suratgar. It was also advocated by UNCTAD or Jeffrey Sachs early on. Egypt’s example shows that this is economically a perfectly sound idea. But a legalistic, formal killer argument came in handy. It was argued that Chapter 11 cannot be applied to sovereigns, because insolvency procedures for firms do naturally not address sovereignty, nor governmental powers in general. This is right as far as it goes. But the US knows insolvency procedures for debtors with governmental powers, so-called municipalities, granting debtor protection to municipalities and their inhabitants: Chapter 9 of Title 11. Reacting to the legalistic counterargument against Chapter 11, internationalising US Chapter 9 was proposed in 1987 (Raffer 1989). Chapter 9 proves that there is no legal argument against insolvency-type protection for sovereigns - the only successful solution, generally accepted with other debtors, can be applied to countries too. Although sovereign debtors borrowing in international capital markets routinely waive immunity, it was proposed that no national court but a neutral arbitration panel should decide. People, especially from the South, have therefore often referred to this solution as FTAP or debt arbitration for countries, apparently preferring these expressions to “insolvency”. FTAP modelled after Chapter 9 was elaborated in detail elsewhere (Raffer 1990, more recent publications in English, French, and Spanish at http://mailbox.univie.ac.at/~rafferk5). Thus only its essential elements are presented briefly when showing its feasibility and implementability.

The Essence of FTAP

The important point is applying the fundamental principles of insolvency protection. 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 payments collides and 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. The normal sanctity of contracts to which the Zedillo Report (p.52) rightly refers is always overridden by debtor protection. Briefly put: debtors cannot be forced to starve their children to be able to pay.

Although creditor claims are recognised as legitimate, insolvency exempts resources from being seized by *bona fide* creditors. Human rights, human dignity, and the debtor's "fresh start" enjoy unconditional priority.

Insolvency relief is not an act of mercy but of justice and economic reason. This shows down to negligible details such as the fact that "forgive" is not commonly used when insolvency procedures reduce debts. Reduction is a right of insolvent debtors – even if they are not "deserving, good boys" - while Developing Countries have to beg for "forgiveness". Insolvency only deals with claims based on a solid and proper legal foundation. No insolvency is needed for odious debts. These are null and void. Demands for cancelling apartheid debts are therefore based on the odious debts doctrine.

The other base of insolvency is the most fundamental principle of the Rule of Law: no one must be allowed to be judge in one's own cause. Civilised insolvency laws applicable to all debtors except Developing Countries demand a neutral institution assuring fair settlements. Creditors must not decide on their own claims. Even at the time of debt slavery creditors were not allowed to decide whether to enslave a debtor. Only judges could do so. Unrestricted creditor domination is an open breach of the Rule of Law, a principle presently preached to Developing Countries by OECD governments. It is also inefficient from a purely economical perspective, as the prolonged debt crisis proves.

Arbitration-Mediation

To start FTAP sovereign debtors could "file" for debt arbitration/insolvency protection by depositing this demand at the UN, e.g. with the Secretary General. Clearly, only debtor governments would have the right to file. It is their sovereign decision. Beyond serving as the organisation where sovereign debtors can file requests for an arbitration process fairly balancing the interests of creditors and the debtor, the UN could play an important role, organising the nomination of arbitrators by the two parties, possibly also providing the limited secretarial services needed by them. Each party would nominate one or two persons, who would elect one further arbitrator. Filing would trigger a stay. Vulture funds could no longer hold debtor governments and other creditors hostage, as lawsuits against the debtor - also harassing other creditors in this case - would no longer be possible.

Arbitration is a traditional mechanism of international law, routinely used by the WTO, NAFTA, and suggested for the now shelved MAI. It is generally quite popular with creditor countries, except when it comes to protecting the poorest. Even in creditor-debtor relations it is not new. Arbitration clauses were fairly standard before World War II. Arbitration to solve disagreement with creditors was part of Germany's London Accord. Incidentally, Raffer (1989) used this case as a supporting example for his proposal. Some recent agreements with private creditors foresee arbitration (Rocha 1999, pp.132ff). Official creditors differ nowadays. In the course of bilateral negotiations under the auspices of the Paris Club its members forced Brazil to change legal requirements in order to "exempt specifically ... Paris Club bilateral restructuring agreements" (*ibid.*, pp.91ff) from arbitration.

The "Zedillo Report" proposes arbitration in matters of taxation and investment, but not for debts, demanding a "new mechanism to mediate relations between debtor and creditor countries" (p.34). No argument is offered why a mechanism needed for frictions between countries regarding taxation and attracting private foreign direct investments is inappropriate for debt problems. The Zedillo Report reflects the Secretary-General's Report (p.64), where an "independent" mediator is proposed, assisted by the IMF and other experts (the IBRD would certainly be considered) as an additional, voluntary option. One might argue that mediation worked in Indonesia 1969. Logically, it can work even with creditors (especially the IMF) absolutely dominating procedures. But creditor behaviour since 1982 does not suggest that sustainable outcomes are likely if creditor domination continues.

Good arbitration comes very close to mediation. Arbitrators should encourage everyone to reach fair and feasible outcomes. Ideally, if creditors, the debtor and organisations representing the population are all agreed, there would *de facto* be no difference. But mediators can only appeal to both sides, provide arguments, help as uninterested parties. Arbitrators can decide, a fact that may be helpful in reaching agreements. But one cannot always assume the ideal case of purely formal "decisions". Arbitrators have to decide on the basis of arguments, data, and information brought forward during the proceedings. Their decisions are thus likely to affect small sums. An improvement over present management, mediation does not confer the same status to debtors as arbitration. They are not equal party. The informal process depends wholly on the good will of creditors, which is not overwhelming. Arbitration has established rules and puts both sides on an equal level - parties with the same rights. There is no reason why sovereign debtors and the world's poorest

should not get this basic protection by the Rule of Law, which mediation would deny. Therefore the Secretary-General's first proposal is preferable, even though mediation was no doubt proposed after conscientious and careful deliberations.

Sovereignty

It has repeatedly been purported that Chapter 9 could not be adapted because countries cannot be put into receivership. A study of the Advisory Council of the German Ministry of Co-operation (BMZ 2000) referred to the "strict supervision" of private(!) debtors in German(!) law to conclude that "political sovereignty and, linked to it, the impossibility to remove governments" would not permit an international Chapter 9. Answering a parliamentary question the Swiss government argued US Chapter 9 to be incompatible with sovereignty because "external authorities" would "as a rule "be "appointed to manage the finances of insolvent states and municipalities" (Bundesrat 2000), even though US-states are sovereign regarding debts (11th Amendment). It remains to be explained how a parliamentary question can be answered so misleadingly wrongly, assuming, of course, that the government drafted its answer with appropriate care.

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 considered unacceptable. A new version containing §904 was allowed to pass. §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. A municipality cannot go into receivership. Unlike in other bankruptcy procedures no trustee can be appointed. §902(5) explicitly confirms: "'trustee', when used in a section that is made applicable in a case under

this chapter ... means debtor". For the legalistically minded one should add that §926 contains an exception if the debtor refuses to pursue avoiding powers, allowing a third party to void specific transactions with particular creditors. Elected officials cannot be removed from office by the court. All this makes Chapter 9 especially suited as *the* solution of sovereign overindebtedness.

Debtor Protection

Municipalities are not expected to stop providing basic social services essential to the health, safety and welfare of their inhabitants in order to pay creditors. They enjoy debtor protection. The US Supreme Court clearly stated in the case of Asbury Park that a city cannot be taken over and operated for the benefit of creditors. There is a public interest in keeping the debtor functioning that overrides creditor interest in higher payments. Tax increases that would depress the standard of living of the municipality's population below the minimum guaranteed to private debtors are clearly illegal. Feasible tax increases have actually been much lower.

The affected population has a right to be heard. They can voice their opinion and object to any plan proposed. The court must hear them, but need, of course, not follow any of the views expressed. Internationally, the population affected by the plan would have to be represented. Trade unions, entrepreneurs' associations, grassroots organisations, religious or non-religious NGOs, or international organisations such as UNICEF could do so, exercising the population’s right to be heard. The right to be heard in fair and equitable proceedings and the possibility of describing the expected effects on the poor in public would certainly have mitigating effects, contributing to an adjustment with a human face. Besides, the arbitrators would have to take particular care to ensure that a minimum of human dignity of the poor in the debtor country is safeguarded - exactly as the court would do in domestic US Chapter 9 cases.

In analogy to US municipalities the money for debt service must not be raised by destroying basic social services. The principle of debtor protection demands exempting resources necessary to finance humane minimum standards of basic health services, primary education etc. for the poor, and funds necessary for sustainable economic recovery. This can only be justified if that money is demonstrably used for its declared purpose. A transparently managed fund financed by the debtor in domestic currency for poverty reduction and a fresh start of the debtor economy would dispel such concerns. Its management could be monitored by an international board or advisory council with members from the debtor as well as from creditor

countries nominated by governments (including the debtor's) and NGOs. As this fund is a legal entity of its own, checks and discussions of its projects would – unlike present strategies - not concern the government's budget, which is an important part of a country's sovereignty. This is an improvement. Counterpart funds have worked quite successfully so far. Regarding decisions on the use of this money the government's situation remains unchanged. Money it had paid creditors would be paid into the Fund.

Equal Treatment of Creditors

All creditors should be treated equally. As a matter of fairness to debtors and other creditors the same percentage must be deducted from all debts. The strong growth of debts, in particular multilateral debts, during 1982-99 in those 23 HIPCs that reached Decision Point by July 2001 does not suggest efficient and successful trouble shooting by multilaterals in charge. Apparently, multilateral loans were given to service other loans, and arrears increased multilateral debts further. Successful debt management would have stopped such growth, because it did not reflect new opportunities after a fresh start and re-gained market access but resulted from delaying a proper solution.

Multilaterals may and sometimes do even gain financially from their errors and failures. One harmful programme or bad project leads to the next, increasing the institution's income and importance. This is at severe odds with any market principle. Equal treatment is one way to hold multilaterals financially as accountable as private creditors usually are for their own decisions affecting debtors. Compensation for damages done within projects, where determining faults and errors is much easier is an issue in its own right. It would reduce the debt burden further (Raffer & Singer 2001).

Multilaterals use the flawed argument that their own rating as borrowers would deteriorate, without "preferred creditor status", increasing costs of lending. If publicly known though officially denied defaults – countries not paying over years - have not reduced the IBRD's rating, properly acknowledged and handled default seems unlikely to do so. Apparently, guarantees by OECD governments rather than their own lending record account for the BWI's ratings. All multilateral development banks have loan loss reserves. Using those as foreseen cannot deteriorate ratings. It cannot increase the costs of future lending, as existing reserves have already been financed by borrowers. In spite of preferred protection MDBs have charged costs of loan loss provisioning, thus having their cake and eating it. Borrowers will continue

to pay mark-ups for provisioning without getting the benefit of the relief option they finance. There might be at worst a marginal effect if interest income from reserves (if there is any) is used to cheapen lenders' margins. However, given the volume of loans, reserves and the possible interest that might be used this does not seem to justify the concerns expressed by the Zedillo Report.

Statutes of multilaterals 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 them, 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 MDBs can survive financial accountability and market risk.

Poor countries are usually soft window clients. Funds, such as IDA, can simply waive repayments without any economic problems, reducing, however, future loan volumes by the amounts waived unless new money is paid in. The Zedillo Report (pp.52f) observes that countries whose credit volumes decline more than IDA-debt-service would be paying for debt relief of others. This is a problematic statement, particularly if one concurs with the Report that present IDA-terms need substantial softening to avoid another HIPC - which means that volume and terms of IDA credits create rather than solve problems at present - and that $1 of debt reduction is worth more than $1 in aid. The discussion on "ownership" suggests that countries are not necessarily keen on all projects - economic results of lending suggest, rightly so (cf. Raffer & Singer 20001, pp.246f) Finally, taking attached conditionality as well as economic efficiency into account, IDA credits are not as cheap as they appear at first sight. If programme lending and particularly new loans enabling debtors to repay earlier loans ceased - as they will after debtors get a fresh start - demand for IDA resources would in all likelihood fall. Introducing financial accountability of multilaterals would prevent quite a few disastrous

projects, which cannot but be in the interest of debtors having to pick up the bill. If - against expectations - credit demand should still exceed supply, those countries that got proportionately more debt relief (thus reducing refluxes proportionately more) might reduce their credit demand proportionately, but not by more than the amount of actual reductions they received. As a dollar in relief is better than a dollar in new loans they would still be better off.

The IMF poses some difficulties. As conditionality was initially not foreseen, loan loss provisions were unnecessary. When conditionality was introduced, no appropriate changes regarding accountability for the Fund's decisions affecting its clients were made. This became particularly problematic once the Fund started massive debt management operations. Introducing financial accountability for its own decisions is thus all the more important. Losses are one way to do so. Gold sales (revaluation) would be one way how the IMF – whose exposure is much smaller - could cover losses.

The possible exception from equal treatment may be Developing Countries. It would not make sense to bankrupt country A by relieving country B. In these cases preferential and differential treatment, strictly according to objective criteria, such as claims affected, the creditor's GDP/head or export income, seems useful. Alternatively, Developing Countries cancelling debts within FTAPs could be automatically entitled to reductions representing the values of their cancellations by their own creditors. It must be underlined, though, that this exception results from the technicalities of implementation and economic sense.

Access to Capital Markets and New Loans

It is often purported that insolvency bars future access to capital markets. If this were true no reorganised firm could ever get any loans - which daily experience proves manifestly wrong. Similarly, the Deputy Governor of the Bank of England, David Clementi, saw no empirical evidence of "any discernible negative long-term effect of a country's prior debt servicing record on the terms and volume of its borrowing."(UN 2000, p.19) After de facto insolvency in 1969-70 Indonesia's public sector had been able to overborrow again so quickly that the Pertamina crisis erupted in the mid-1970s.

Economic logic suggests that long term investment and capital flows needed for development will rather not flow into crises countries, but become available for profitable projects once the

crushing debt overhang is removed and the debtor country has started a new financial life based on regained economic viability.

Systemic Role

Last but not least FTAP is needed as an important part of a New International Architecture, a disincentive to irresponsible lending. Sure to lose their money eventually, lenders would stop lending if previous loans were not put to efficient use. Debts could not accumulate as they did. If FTAP had existed in the 1970s the debt burden would be much lower, maybe there would not even be any debt crisis as lenders would not have operated on the assumption that they will get paid. It would have been clear from the start that all creditors would be bailed in not bailed out. The amount of multilateral activities would probably decrease to fewer but economically more viable projects. This is desirable as no project at all is preferable to a costly flop - at least for those who have to pay for it.

Conclusion

A sustainable solution removing debt overhang is the precondition for successful development and for the Financing for Development Initiative. Otherwise, all development activities remain at risk. Some aid will continue to be diverted for bail-outs, resources cannot be mobilised as investors will rightly fear the next, predictable crisis. New money for developmental investments will not flow because the debt problem is not solved yet. A sound basis to start with renewed development efforts is mandatory. FTAP is socially, legally, and economically indicated. Without this orderly, efficient, and fair procedure crises are prolonged and damage is inflicted unnecessarily, mostly to the poorest, so-called vulnerable groups. The very foundation of the Rule of Law demanding neutral institutions ensuring fair settlements and the human right of debtor protection must not be denied to any human being, whether living in the North or in the South. Whoever looks like a human being must be treated as such. Arbitration has to prevail over arbitrariness – also with regard to sovereign debts.

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