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Arbitration to Solve the Debt Problem

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A major international initiative is needed with regard to international debt management that has dragged on for too long. The history of sovereign overindebtedness shows that protracted manœvring cannot make unpayable debts paid. Large percentages of debts must eventually be cancelled - at the cost of unnecessary human suffering if a quick and efficient solution is denied.

Creditors have already recognised that overindebted debtors will not be able to repay fully, but their unhampered power has prolonged rather than solved the problem. Both HIPC-Initiatives, steps into the right direction, illustrate the problem well. Some features recall - though remotely - customary features of insolvency procedures, but they fall short of the needs of debtor economies because creditors remain all powerful, judge, jury, bailiff, interested party, witness, occasionally even the debtor's lawyer, all in one. No decent legal system allows this. The very idea of the Rule of Law prohibits precisely what has happened to sovereign Southern debtors. Decisions which part of debts is unpayable if the human dignity of people in debtor countries as well as their economic future is to be safeguarded must not be made by either interested party, but must be reached by a fair process balancing the interests of creditors and the sovereign debtor.

Within all creditor countries such procedures (called insolvency) exist. Courts, not creditors decide on debt reduction. The basic function of any insolvency procedure is solving a conflict between two fundamental legal principles in a process chaired by a neutral person or institution. It is the most fundamental principle of the Rule of Law that one must not be judge in one's own cause. In a situation of overindebtedness the right of *bona fide* creditors to interest and repayments collides with the principle recognised generally (not only regarding 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, all other debtors but the people in the South cannot be forced to starve their children to be able to pay more. Although claims are recognised as legitimate, resources are exempted from being seized by *bona fide* creditors. Human rights and human dignity of debtors, but also an economic fresh start are given priority over unconditional repayment. It is important to emphasise that insolvency deals with claims based on a solid and proper legal foundation.

The only question is whether such procedures can be used in the case of sovereign debts. Adam Smith advocated it. Clearly, the insolvency of firms (Chapter 11 in the US) cannot be applied, but US Chapter 9 procedures show that these principles of justice and fairness can be implemented internationally as well. Designed and used for decades in the US as a solution to the problems of debtors vested with governmental powers (municipalities) Chapter 9 can be easily applied to sovereign borrowers. Like all good insolvency laws it combines the need for a general framework with the flexibility necessary to deal fairly with individual debtors. Introduced in the US for the very purpose to avoid the kind of debt management practised internationally, it was refined, e.g.

when New York could not file under Chapter 9 because of technicalities, and a *deus ex machina* - the Municipal Assistance Corporation - had to be created.

Internationally, arbitration, a traditional mechanism of international law, has to replace national courts, but the essence of insolvency protection must not be denied to poor people in the South. A fair and transparent arbitration process on debts modelled after domestic US Chapter 9 insolvency applying the Rule of Law, the human right of debtor protection, and economic efficiency to sovereign debts is needed.[*] As creditors have officially acknowledged both the need of some debtor protection and debt reduction meanwhile, arbitration remains the one necessary element of a proper and fair solution from which creditors dominating debt management presently still shy away. Proposing international insolvency and proposing arbitration are therefore essentially equivalent as regards solving the problem.

Apart from being an open breach of the Rule of Law, unrestricted creditor domination is also inefficient from a purely economic perspective. Unsurprisingly too little has been given to late, enormous damage has been inflicted on debtor economies, and debts have increased in the books of creditors, growing further by capitalised arrears. As anyone familiar with basic mathematics can verify, creditors unwilling to grant sufficient relief when necessary, increase irrecouperable debts. Claims keep growing on paper, further beyond the debtor's economic capacity to repay. 'Phantom debts' come into being, existing only on paper, nevertheless damaging the debtor's economic future. They allow creditors to exert pressure, but 'forgiving' them does not mean losing money. Money one cannot get cannot be lost. Deleting phantom debts is simply acknowledging economic facts, or "generosity" for free.

Under Chapter 9 US laws protect both the debtor's governmental powers and the living standards of the indebted municipality's population. §904 limits jurisdiction and powers of domestic courts. The court may not interfere with the choices of a municipality as to what services and benefits it will provide to its inhabitants. The court's jurisdiction depends on the debtor's volition and cannot be extended beyond it. As sovereignty cannot and does not cover more than §904, the debtor's situation is *de facto* like a sovereign's. Chapter 9 proves that debtor protection can be extended to the population of debtor countries. The openness and transparency of the bargaining process are particularly interesting. Individuals affected by the plan have a right to be heard. Creditors are to receive what can be "reasonably expected" under given circumstances. Their interests have to be taken into account fairly as well. Public interest demands that the debtor must go on functioning as a public entity providing basic services in fields such as health, welfare or security to its population.

Internationally, a neutral arbitration panel - a traditional tool of international law - would have to replace national courts. To start the process, sovereign debtors could "file" for debt arbitration/insolvency proceedings 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 to do so. Beyond serving as the organisation where a sovereign debtor can file its request 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 side nominates an equal number

[*] More detailed information in English, French, Spanish, and German is available at http://mailbox.univie.ac.at/~rafferk5

of arbitrators, who in turn elect one more member to reach an uneven number (ideally not more than five). Arbitrators have to proceed according to the main principles of the US Chapter 9, deciding on procedural matters as they come up. Since these principles can be applied immediately no further technical work is required. An independent entity, not creditors, would have the power to decide finally, if no agreement is reached. The affected population would have a voice, represented by NGOs, trade unions, employers' associations, grassroots organisations, or international organisations such as UNICEF, exercising the population's right to be heard.

Presently, both creditors and debtors employ qualified personnel managing reschedulings or other debt related issues. In an international Chapter 9 these people would simply do what they have done so far, negotiating and arguing their points before temporary arbitration panels instead of among themselves.

Once a workable composition plan is agreed on, panels can be dissolved. No new bureaucracy would come into being. If further disagreements should develop later on the same persons (or, if necessary, other arbitrators) could reconvene to solve this (these) issue(s). Arbitration by a neutral body is the basic element of a fair and humane solution according to the principles presently demanded by OECD governments as donors from their debtors, but denied to them when it comes to creditor-countries' own claims.

Arbitration is increasingly applied to solve international problems. The WTO or NAFTA are examples, OECD governments wanted to make it part and parcel of the Multilateral Agreement on Investment. Arbitration has already been part of debt arrangements, such as the London Accord with Germany in 1953. By the way, my argument in 1987 that internationally neutral arbitration panels must replace bankruptcy courts was based on Germany's example. Loan agreements in the 1930s routinely stipulated it to solve disagreements. Agreements between Nigeria and Uruguay with private creditors are examples in the recent past. The German Commerzbank pointed out that private creditors would not object to debt reduction by arbitration in cases of extreme debtor distress, if it is fair and the burden is shared among all creditors. It pointed out that this was presently not the case as International Financial Institutions (IFIs) managing debt renegotiations have privileged their own claims vis-à-vis those of other creditors. Themselves creditors IFIs cannot fulfil the role of arbitrators.

Schemes to protect a minimum standard of living must be part of every international composition plan. 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 basic social services. Subsidies and transfers necessary to guarantee humane minimum standards to the poor must be maintained. Funds necessary for sustainable economic recovery must be set aside. The principle of debtor protection demands exempting resources necessary to finance minimum standards of basic health services, primary education etc. This exemption can only be justified if that money is demonstrably used for its declared purpose. Not without reason NGOs as well as creditors are concerned that this might not be the case. A transparently managed fund - as proposed by Ann Pettifor of Jubilee 2000 UK - financed by the debtor in domestic currency would guarantee that money exempt is used for the poor and for expenditures necessary for economic recovery of the sovereign debtor. Its management could be monitored by an international board consisting of members from the debtor and from creditor countries. Its members could be nominated by NGOs and governments (including the debtor's). As this fund is a legal entity of its own, checks and discussions of its projects would not concern the

governments budget, which is an important part of a country's sovereignty. Counterpart funds have worked quite successfully so far and are demanded by civil society.

This kind of arbitration would fulfil the demands of donor governments: participation, transparency, and respecting the Rule of Law. It is also a necessary part of a meaningful international financial architecture, because its very existence would be a strong disincentive to careless lending, to pushing loans on countries as happened during the 1970s when lenders operated on the assumption that sovereign loans will always be repaid eventually. As it could be done with the stroke of a pen if powerful creditor governments agree, advocacy by the UN and NGOs is necessary. Both human rights and the Rule of Law demand a fair and open arbitration process modelled after US Chapter 9 to re-create the preconditions for development and for reducing poverty. No difficult and costly legal or administrative framework is necessary. The Paris Club functions without a legal base. Only the will of important creditor countries (e.g. G7) is needed. Sadly, arbitration - quite popular in other cases - is denied when it comes to apply the human right of debtor protection and the Rule of Law to the poorest in developing countries. Without such an orderly and fair process crises are prolonged and damage is inflicted unnecessarily, mostly to the poorest, so-called vulnerable groups. People in debtor countries need justice and economic sense, not generosity - the same protection of their basic needs and human dignity any other debtor enjoys. Put into a nutshell: whoever looks on this globe like a human being should be treated as one.