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Debt Relief for Low Income Countries: Arbitration as the Alternative to Present Unsuccessful Debt Strategies

Introduction

Poor countries' debt problems briefly veiled by overliquidity during the 1970s had existed long before the conventional date of August 1982. The Pearson Report (Pearson *et al*, 1969, pp.153ff) prepared on request of the president of the IBRD, strongly recommended debt relief. Its finding that debt management had emphasised spending cuts and credit restrictions, neglecting the need to sustain sound development outlays sounds quite modern and topical. Nevertheless it took many years, until the Cologne Summit of 1999, before the negative effects of post-1982 debt management on poverty were explicitly recognised officially.

Identifying insolvency rather than illiquidity as the problem, Abbott (1972) already proposed debt cancellation. Accepting the need for debt alleviation major creditors adopted the so-called Retroactive Terms Adjustment (RTA) in 1978, measures to provide debt relief and to improve the net flow of bilateral official aid to Low Income Countries. Their debts were mostly caused by official flows, including aid. One should mention the co-responsibility of official creditors, who decide and monitor where and how their money is spent. The programme's long-winded, clumsy name documents the creditors' desire to avoid the words debt relief or debt cancellation, not to mention insolvency. This steadfast refusal to recognise realities officially has remained the most important hindrance to proper debt management and to a viable solution of the crisis until the present day.

The IMF started "Structural Adjustment" in Africa well before 1982 according to *Finance & Development*: after 1973 (Kanesa-Thasan 1981). Officially, the IBRD started its involvement in programme lending in 1980, but it had exerted influence in connection with projects before. The Bretton Woods Institutions (BWIs), particularly the IMF, did not arrive on the scene after August 1982 to solve a problem created by others, but they had been part of the process leading to it (cf. Raffer 1994). Their type of adjustment did not prevent the debt crisis. The date 1982 disguises the long and dismal record of debt management and the ineffectiveness of the policies enforced by the BWIs in restoring the sustainable economic viability of debtor countries.

With this background, this paper will first briefly assess the damages caused to the poorest countries by protracted unsuccessful debt management, showing why it is both economically inefficient, and denies people in debtor countries basic human rights granted to all other debtors, as well as minimum standards of the Rule of Law. Finally, debt arbitration modelled after the basic principles of US Chapter 9 insolvency for debtors with governmental powers will be briefly sketched, taking the particular situation of poor countries into account.

Creditor Caused Damage

All historical cases of sovereign overindebtedness show that large percentages of debts must eventually be cancelled. Since the Toronto Terms this is officially recognised for poor countries as well, but their debt overhang has increased, because creditors dominating debt management have always given too little and too late. Protracted manœvring added unpayable debts, burdened the debtor, made debt relief look more expensive than it is.

The economic inadvisability of present debt management causing unpayable debts to grow further can be shown with extremely basic mathematics. At an interest rate of m%, no amorti-

sation, and actually paid interest service of n% (n < m) debts grow by (m-n)% annually. Capitalising arrears over k years at constant m and n multiplies debts by $[1 + (m-n)]^{(k-1)}$ if arrears occur first at the end of year 1. This increase comes on top of already unpayable debts. The burden increases, the percentage of debts that can actually be serviced is continuously reduced. A simple illustrative example assuming m = 5% total debts of $1000 at the beginning of year 1, and a slightly increasing n of initially m/2 shows that debts grow by $247 over ten years (cf. Raffer 1998). More sophisticated assumptions, such as introducing amortisations, would not change the basic mechanism. Capitalised arrears increase debt stocks, as anyone familiar with basic mathematical operations can verify. The gaps between debt service due and actually paid widen in the example, although the debtor pays steadily more debt service, possibly so because of the lemon squeezer effect of "Structural Adjustment". Debts accumulate in the books of creditors with increasing shares of "phantom debts" (*ibid.*), debts without any economic base as they are uncollectible. Caused by creditors unwilling to acknowledge insolvency, they boost nominal debts to ever more unrealistic heights, making debt reductions to economically sustainable levels appear costlier and costlier on paper. Forgiving $520 at the end of year 2 would have restored the debtor's viability in Raffer's numerical example. Finally, $672 must be cancelled to allow honouring all obligations. $152 - totally irrecouperable, pure phantom debts - result from the creditor's unwillingness to grant timely reduction.

The assumption that actual payments are always roughly half the payments due is quite optimistic. Sub-Sahara Africa (SSA) has paid less than one fifth of the amounts due recently (see Table 1). Despite high net transfers HIPC-debts have kept growing. The IBRD (1997, p.42) acknowledged the effects of delaying relief:

> 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.

The slowdown from an annual growth rate of 12.77 per cent to 3.28 per cent in the 1990s was achieved by a shift towards more grants, higher concessionality and forgiving ODA debts. The IBRD (*ibid*., p.44) acknowledged: "In many HIPCs the negative impact of external debts seems to come more from the growing debt stock rather than from the excessive burden of debt service actually paid." In plain English: countries pay little, capitalising a lot of arrears. According to UNCTAD (1998, p.127) two thirds of the increase in SSA's debt since 1989 was due to arrears. Such figures clearly prove a situation of technical insolvency, the building up of phantom debts. Secondary markets for private claims or internal valuations by official creditors reflect phantom debts. The *Washington Post* (16 March 1999) reported that $3 billion of "forgiven" debt would actually mean "maximum budget cost" of $190 million, as the rest had been "essentially written down or written off as uncollectible." Economically these claims were valued at 6.33 per cent of face value. At the Cologne summit Chancellor Schröder told in an interview that essentially debts were forgiven that could not have been collected. By including phantom debts official figures on the cost of debt relief are boosted. They hide the fact that real costs of meaningful debt reductions - in the sense of money that can actually be recouped, and which can therefore actually be "forgiven"- are much lower. Economically, one cannot lose money one cannot get anyway.

The large debt overhang of poor countries is not at all reflected in conventional debt indicators, the Debt Service Ratio (DSR) and the Interest Service Ratio (ISR). Both divide actual payments by export earnings. Therefore, both suffer from ambiguity, being equally low if a

country is fairly debt free or if a heavily indebted country simply cannot pay. The less it pays - the higher its debt overhang becomes - the lower these indicators will be, while arrears accumulate. As arrears are the clearest sign of a debt overhang, the relation between payments effected and payments due

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

was proposed as a better index (Raffer 1996). It is 1 if all payments are made on time, zero if the debtor does not pay at all. In contrast to conventional indicators it is unambiguous. Theoretically DSR_d^*, which we may call the *real* debt service ratio, must include all payments due but not effected including interest arrears and amortisation of short term debt, all amounts rescheduled early because they could not have been honoured when contractually due, and loans solely granted to avoid formal default. Table 1 includes arrears of interest and principal as published by the IBRD (2000), rescheduled interest and principal, debt "forgiven", and capitalised interest. Figures on "Debt Stock Rescheduled" are not included because the IBRD's explanations suggest that this is not exclusively principal due or already in arrears during the year of rescheduling. Relevant data permitting to allocate rescheduled principal to the years when it was originally due, are not available. For such practical reasons DSR_d^* in Table 1 - while an improvement on traditional debt indicators - still understates the burden of debt service.

Table 1: The Evolution of the Debt Overhang of Poor Countries

	1980	**1990**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
SSA									
DSR	7.2	12.9	9.2	14.6	15.3	14.2	14.7	14.7	14.8
DSR_d^*	11.4	55.6	73.2	94.7	83.8	79.2	73.8	83.3	n.a.
DSR/DSR_d^*	0.632	0.232	0.126	0.154	0.183	0.179	0.199	0.176	n.a.
LICs									
DSR	n.a.	21.4	18.6	17.8	17.9	16.6	15.1	15.4	14.7
DSR_d^*	n.a.	46.3	47.0	47.2	43.9	39.7	33.6	35.3	n.a.
DSR/DSR_d^*	n.a.	0.462	0.395	0.377	0.408	0.418	0.449	0.436	n.a.

LICs Low Income Countries
n.a. not available

Source: DSR from IBRD (2000), rest calculated from this source

Table 1 shows DSR_d^* for the two groups of poor countries for which sufficient data are published by the IBRD (2000). Contrasting the two DSRs in Table 1 shows the full extent of the debt burden, and contrasts the conventional and my indicator. Although some slight improvements are recognisable during the second half of the 1990s, LICs as a group still paid perceptibly less than half of what they should have paid. The situation of SSA is dramatically worse. The average/representative country of each group is clearly insolvent.

Data necessary to calculate DSR_d^* for Severely Indebted Low Income Countries (SILICs) or HIPCs are not published there. For SILICs interest arrears alone were 83.4 per cent of total debt service. Adding only these would result in a DSR_d of 45.3 instead of 24.7 obtained on the cash base. Sufficiently detailed data for the SILIC-group were published by the *World Debt Tables*, the predecessor publication of *Global Development Finance*, but no longer. Now one would have to calculate them by adding individual country data. It is surprising too that simi-

lar data on the HIPC-group are not published there either although so much attention is focussed on them. Embarrassingly high arrears officially highlighting the insufficiency of present debt policies cannot be immediately excluded as a logical reason.

The IBRD (1992, p.10ff, stress in original) recognised the fact of insolvency at the beginning of the 1990s, when it claimed that the debt crisis for big Latin American debtors was over, and actual insolvency relief thus not necessary:

> *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.

This damaging delay was caused by defenders of the so-called illiquidity theory in the 1980s, notably the IMF and the IBRD, positing that the debt crisis was a liquidity, not a solvency crisis. As most explicit advocates they supported this theory by overly optimistic forecasts "showing" that debtors would "grow out of" debts. Neither Bank, Fund nor other official creditors see their delaying tactics as a reason for compensating at least part of the damage caused by them.

In spite of the IBRD's insightful statement insolvency has remained anathema with official creditors, especially with International Financial Institutions (IFIs), including the Bank. The British government is one exception, strongly and repeatedly advocating more adequate debt relief, from the Toronto Terms to the Mauritius Mandate. Its Trinidad Terms were so bold that it took the Paris Club years of delay to accept them. Doing so earlier would have defused the debt problem considerably. Typically, official creditors responsible for delays qualified as wrong and damaging to debtor economies by the IBRD, go on delaying.

From "Structural Adjustment" to HIPC II: The Fatal Flaw of Creditor Dominance

Instead of referring to the substantial amount of literature on whether "Structural Adjustment" worked, suffice it to point out that after over a quarter of a century sustainable economic viability has not been restored in one single SSA-country. This in itself is a clear verdict, comparable to professional opinion on a shoe salesperson not selling a single pair of shoes for decades.

The IBRD (1989, p.21) referred to the problem that "Structural Adjustment" is particularly ill suited for poor countries, calling it "also more severe than that of other HICs [Highly Indebted Countries]", although in the context of middle-income countries in SSA. In spite of "slightly lower" debt-exports ratios these African countries

> have a lower capacity to adjust to their debt overhang...Their export structures are generally more rigid, with a higher share concentrated in a few primary commodities; export growth has been erratic and lower on average.

These problems are much more pronounced in poorer countries, such as Least Developed Countries, as their exports and production structures are even more rigid and concentrated.

The ineffectiveness of "Structural Adjustment" was also recognised by various "Terms" of the Paris Club. Claiming at Venice that all could be repaid, official creditors have meanwhile arrived at Cologne Terms with 90 per cent Net Present Value (NPV) reduction on eligible debts. The economic sense behind a "solution" such as the debt service option, under which this reduction is achieved "through concessional interest rates and a repayment period of 125 years, including 65 years of grace" (IBRD 2000, p.171) remains unclear at best. Similarly, the "'bullet' option" with an interest rate of 0.0001 per cent (the IBRD does nor dare write over how many years) would be ridiculed in the case of all other debtor-creditor relations. Politically, though, such solutions provide a long term leverage over poor countries.

The high percentages of debt relief quoted by the Paris Club are prime examples of misleading figures making insufficient debt relief look "generous". Only so-called pre-cut-off debts are eligible for relief. The cut-off date is when the debtor asked the Paris Club for debt relief the first time, which can be early in the 1980s. With an early enough cut-off date 100 per cent "debt forgiveness" may mean a reduction of less than 1 per cent of total debts. Eventually debt relief converges to zero, while percentages "forgiven" converge to 100 - in plain English: towards 100 per cent Paris Club "debt relief" without a single cent actually forgiven.

Errors producing insufficient debt relief initially are transmitted, compromising viable solutions in the future. Too little relief at the first try causes new problems and becomes difficult if not impossible to remedy later under this system. Since creditors have always been reluctant to recognise the dimension of the problem and estimates of future export incomes and growth by IFIs on which relief was based have been notoriously "optimistic", first relief measures by the Paris Club were apparently too limited. Creditors thus foiled a quick and proper solution, as the changes from Venice to Cologne prove clearly.

Applying the NPV-concept to debts is also highly misleading. Discounting future debt service payments with non-concessional interest rates reduces debt burdens considerably on paper. The NPV of all HIPC-debts was about $190 billion at the end of 1994, while their nominal debts were $241 billion (IMF 1997, p.15). But sustainability based on NPVs is meaningless. The concept is used for investment decisions as streams of revenues and outlays can only be compared meaningfully at the same point of time. It makes sense there because $100 today is actually equivalent to $105 after a year if invested at 5%. Discounted values provide useful information for comparing expected streams of payments. Discounting to calculate grant elements of aid may make sense too, even though assuming a 10 per cent market interest rate is unwarranted, exaggerating donors' "generosity".

But in the case of debts discounting at market interest rates simply states that if the debtor had the NPV today and could invest it at the discount rate, all debts would be covered - logically true but unhelpful. HIPCs, e.g., 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 means that these terms are already too tough for them. Using NPVs is like demanding a malnourished, burdened person to run 100 meters in 13 seconds, rightly drawing attention to a 30% element of concessionality in comparison with 10 seconds.

HIPC-thresholds of "sustainability" were arbitrarily chosen, obviously with the scope of keeping nominal costs of debt reductions as low as possible. Thus countries may either pay as much after debt relief as before or even more. The 150/15 benchmarks considered "generous" for the poorest countries by the Cologne Summit compare unfavourably with Germany's debt

indicators before the London Accord granted debt relief in 1953. Its debt service ratio had been less than 4 per cent (Hersel 1998), which was considered unsustainable for Europeans in contrast to 15 per cent for HIPCs now. In 1952 Germany's debt export ratio was 85 per cent, well below the 150 of Cologne, even the IBRD's (2000, p.142) upper limit for "Less-indebted" countries. The successful economic policies Germany was allowed to pursue, characterised by the term social market economy (*Soziale Marktwirtschaft*) were the very opposite of BWI-type structural adjustment. All in all, Germans were lucky not to depend on Cologne-type generosity and the BWIs.

Countries that meet all objective economic criteria to be HIPCs are excluded. Although in the same situation they are denied the same treatment simply because creditors are afraid of costs. Indonesia, once one of the IBRD's miracles, became a SILIC because of the Asian crisis resulting from capital account liberalisation advised by the BWIs. Although the Bank does not give percentages, simple divisions of total debts in present value terms and debt service by export revenues shows that Indonesia had a debt/exports ratio of 251.75 per cent, and a DSR of 33 per cent in 1998 (IBRD 2000, vol.1, p.145), both above the Cologne thresholds of 150 and 15 respectively. Economically and judged by objective indicators it should qualify for HIPC now. But as the amount of debts is substantial ($150.8 billion) treating Indonesia as indicated by objective criteria would be costly on paper. Creditors thus deny this with economically unconvincing, bureaucratic reasons.

A similarly interesting example is Nigeria, another SILIC. Classified a HIPC initially, it was removed from the list in 1998 as no longer meeting the criteria. Its indicators were 250.14 and 11.22 in 1998. However, the low DSR results exclusively from the fact that Nigeria - unable to pay as due - has been accumulating huge arrears. Since 1993 debt service was a fraction of interest arrears on long term debt. Arrears of principal were always much higher than these interest arrears during that period. Simply by adding interest arrears Nigeria's DSR would have been slightly above 35 per cent in 1997. Adding all principal arrears shown by the Bank for 1997 would result in a DSR of 90.93 per cent (IBRD 2000, vol.2, p.418). In 1998 the situation was even worse. Dividing actual debt service plus interest arrears - as shown by the IBRD - by exports rendered 60.4 per cent. Adding principal arrears in the numerator brings the result to well over 160 per cent, not surprisingly so, as arrears on long term debt were slightly higher than export income. Conveniently for creditors the country's very debt overhang - producing a low conventional DSR by disregarding substantial arrears - seems to provide a "reason" to argue that it is not highly indebted, therefore not in need of HIPC treatment. One wonders whether the still high DSR threshold might even provide a means to increase actual debt service to at least 15 per cent.

Unrestricted creditor domination is the main problem of present debt management. Too little is being granted too late, thus prolonging the crisis and human suffering. Decisions are made arbitrarily, not depending on economic needs but on how "generous" creditors feel at a given moment. One has to agree to the IBRD's (2000, p.68) conclusions regarding HIPCs:

> Many more infants will die either at birth or before they reach the age of five than in other developing countries, and far fewer will go to school. ... the vast majority of people living in HIPCs have seen no improvement in their lives for more than two decades.

This is not at all a new insight. As early as 1987 the IMF's Managing Director, Michel Camdessus, admitted at ECOSOC that the poorest “too often ... carried the heaviest burden of adjustment” (*IMF Survey* 29 June 1987, p.195). Obviously, this was not seen as a reason to ex-

tend the minimum of debtor protection required by human rights to the South, whose poor have been subject to a treatment that would be impossible in the case of any debtor within any OECD country.

Debt Arbitration Modelled after Chapter 9

Already Adam Smith (1979, p.930) recommended state insolvency as the " the measure which is both least dishonourable to the debtor, and least hurtful to the creditor". Immediately after 1982 David Suratgar, a British banker, recommended to apply corporate insolvency to countries (US Chapter 11 insolvency). This proposal was taken up and discussed widely. Economically it is perfectly sound. Private creditors applied Egyptian insolvency laws to solve the Egyptian debt crisis of 1876. After a surprisingly short time this concept (including debtor protection in favour of the population) was economically successful for creditors and debtor alike (Dommen 1999) - a vivid contrast to present policies of official creditors. There is, however, a legal killer argument: as reorganisations of firms do by definition not take sovereignty into account this proposal is not legally viable for sovereigns. Technically right, this is a superb subterfuge for unwilling creditors. But the little known US Chapter 9 insolvency is applicable to sovereigns. Designed and used for decades in the US as a solution for debtors vested with governmental powers - so-called municipalities - its basic principles can be immediately applied to sovereign lending. Like all good insolvency laws it combines the need for a general framework with the flexibility necessary to deal fairly with individual cases.

As this idea, initially proposed in 1987, has been elaborated in detail elsewhere (cf. Raffer 1990; Raffer & Singer 2001, more recent papers at http://mailbox.univie.ac.at/~rafferk5) the essential elements of this solution with a human face are presented briefly. In the US Chapter 9 deals with debtors having governmental powers, and protects those affected by the composition plan, giving them a right to be heard. §904 titled "Limitation on Jurisdiction and Powers of Court" is the crux, making it clear that the court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators. The concept of sovereignty does not contain anything more than what is protected by §904 in the case of municipalities. The present version of §904 formulates with greatest 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.

A municipality cannot go into receivership. Elected officials cannot be removed from office by the court - but, of course, by voters at the next elections. All this makes Chapter 9 especially suited as *the* solution of sovereign overindebtedness. The transparency and participation established by the right to be heard of the affected population are an additional bonus.

During the Great Depression Chapter 9 procedures were introduced precisely to avoid prolonged and inefficient negotiations and reschedulings in the case of overindebted US municipalities, the kind of "debt management" practised internationally for decades. A first draft by municipalities themselves that did not bar interventions into the governmental sphere was rejected by lawmakers as unconstitutional (Spiotto 1993). Creditor interventions usual in developing countries nowadays were considered inacceptable. A new version containing §904

was enacted. Technically, Chapter 9 thus offers the legal possibility to implement an economically sensible solution for sovereign debtors, finally heeding Adam Smith's advice.

Internationally, one technically minor change of its basic framework is necessary: a neutral court of arbitration, instead of national courts to avoid decisions influenced by national interests of creditors or debtors. Therefore NGOs, particularly from the South, have often referred to this solution as a Free and Transparent Process of Arbitration (FTAP), apparently preferring to avoid the word insolvency. Arbitration is a traditional mechanism of international law, incorporated into the WTO framework, NAFTA, and suggested for the now shelved MAI. It is generally quite popular with creditor countries, except when it comes to protecting the poorest.

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 sovereign debtors can file their 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.

Clearly, the arbitration panel could sit anywhere, including the debtor or its neighbouring countries. It was never demanded that the panel "be headquartered in a neutral country that is neither an active international lender nor borrower", as Eichengreen (1999, p.126) erroneously characterised my proposal. One may suppose this error to stem from the passage: "The reason why no court, whether located in a creditor or debtor country, should chair the procedures is self-evident: its impartiality is not guaranteed" (Raffer 1990, pp.304f), which refers to courts, not courts of arbitration. Language apart, the illustrating example - the US Court of Appeal for the Second Circuit of New York, definitely no court of arbitration - proves this beyond doubt. Although other authors - e.g., Rogoff (1999) - do not make this remark, Eichengreen's error nevertheless suggests the use of "panel" whenever discussing arbitration. This might also be helpful to differentiate the proposed *ad hoc* panels from a permanent court of arbitration. Technically, a permanent entity could handle such cases as well. But *ad hoc* panels can be established much more quickly, and too much time has already been wasted because of creditors. Furthermore it is to be hoped that - once the backlog of cases is resolved - this kind of arbitration will not be needed frequently. Finally, *ad hoc* panels might have the advantage of being custom made for each case.

In the US people affected by the plan have a right to be heard. Internationally, this would, of course, have to be done by representation. The interests of the population affected by the plan could be defended by trade unions, entrepreneurs' associations, grassroots organisations, religious or non-religious NGOs, or international organisations such as UNICEF. 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 a US Chapter 9 insolvency case. This procedure differs fundamentally from present debt management where creditors are judge, jury, experts and bailiff all in one, sometimes even the debtor's lawyers.

IFIs, such as the BWIs, cannot be arbitrators. They are party, both controlled by majorities of creditor states and creditors in their own right. Thus proposing the IMF to fulfil the role of

the panel is absurd. Barring IFIs from being arbitrators is but fair to other - particularly to private - creditors, as IFIs have not been unbiased when making decisions affecting their own claims as well as those of other creditors. The publication *Emerging Markets this Week* (no. 26/1999, October 15; stress in original) of the German Commerzbank expresses this concern clearly: the Bretton Woods Institutions "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." Familiar with insolvency as an appropriate means to solve debt problems in other cases, people from the banking community usually see the proposal in a more professional way than official creditors once it becomes clear that this mechanism must be fair to all sides. It would not be generally accepted if it were not.

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 the word "forgive" is not commonly used if and when insolvency procedures reduce debts. This is a right of insolvent debtors, while poor countries can only beg for "forgiveness". Substantial shares of present debts exist only because of prolonged, unsuccessful debt management by official creditors refusing necessary debt relief over years. Growing phantom debts crush economic recovery and impoverish people further. This increased debt burden is creditor caused damage, a damage done by delay, as even the IBRD conceded. Insolvency procedures established themselves as *the* generally accepted mechanism because they are the best solution of a debt overhang. The question is thus simply whether they can be adapted to the specific case of sovereign debtors. Chapter 9, successfully applied within the US over decades, proves that there is no reason why this should be impossible. It should be clear that we are talking about a traditional tested mechanism to solve the problem of crushing debt burdens, and it does not matter whether one calls its insolvency or FTAP, or by whatever other name. The difference to present practice is arbitration instead of arbitrariness. Having made this proposal in 1987 (Raffer 1989) under the name international Chapter 9 insolvency, I shall, however, stick to insolvency.

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 unconditional repayment.

This difference between debtors has not gone unnoticed. The UN Commission on Human Rights commissioned an independent expert to research the effects of present debt policies and foreign debt "on the full enjoyment of all human rights, particularly economic, social, and cultural rights." (Cheru 2001, p.5). In 2000 Italy's Parliament passed a law (Legge 25 Luglio 2000, no.209) on debt relief also requesting the Government to obtain a ruling by the International Court of Justice on the consistency between the international regulations governing developing countries' foreign debt and the general framework of legal principles and human and people's rights. At their meeting at Bologna in June 2001 the Union of Catholic Italian Jurists has addressed the Genoa Summit in this matter, demanding in particluar that Italy's government comply with this legal obligation, stressing the need to take the survival and dignity of indebted peoples into account.

It is important to emphasise that insolvency only deals with claims based on solid and proper legal foundations. In the case of odious debts, e.g., no insolvency is needed. These are null and void. Demands for cancelling apartheid debts are therefore based on the odious debts doctrine.

Debtor protection is one of the two essential features of insolvency. The other 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 prisons creditors were not allowed to do so - in contrast to present international practice violating this very minimum required by the Rule of Law most flagrantly. Unrestricted creditor domination is not only an open breach of the Rule of Law, a principle presently preached to Developing Countries by OECD governments, but also inefficient from a purely economical perspective, as the prolonged debt crisis proves.

In analogy to the protection granted to the population of indebted municipalities by US Chapter 9 the money to service a country's debts 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 - a "fresh start" as US insolvency laws put it. This 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 always be so.

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 IMF and the IBRD Ann Pettifor (1999) proposed a Poverty Action Fund as a means to guarantee that the money is 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 with members from the debtor as well as from creditor countries. They 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 government's budget, which is an important part of a country's sovereignty. Counterpart funds have worked quite successfully so far. Furthermore the government's situation does not change. Money it had paid creditors would be paid into the Fund. In both cases it is not at the government's disposal. Via the Fund, however, the population benefits. Represented at the board the government has more say about the use of this money. Unless one assumes governments absolutely inimical to using money for their own people, preferring to give it to creditors, this solution is also an improvement for governments.

Resources exempt to finance such Funds are, of course, not phantom debts, but affect claims that could economically be honoured if debtor protection is denied, if human rights are valued less than a few dollars more repaid. They are payments which creditors actually waive as they could actually collect them. In contrast to phantom debts they are real costs to creditors.

Multilateral Claims: A Special Problem of Poor Countries

The poorest countries with little debt to private creditors but substantial multilateral shares cannot benefit from debt reduction schemes if multilaterals are excluded. In SSA and for LICs multilateral shares of all public and publicly guaranteed long term debts were 34.3 and 32.9 per cent respectively in 1999. Therefore the demand of symmetric treatment of all creditors is of particular importance. But, as the Ecuadorian example shows, symmetric treatment is also needed in poor Middle Income Countries. Although private creditors had granted a generous

reduction of 45 per cent under Ecuador's Brady deal, this was only reflected in a very small blip downwards in Ecuador's debt time series, as new official loans pushed debts up again. If all creditors had cancelled 30 per cent, commercial banks would have saved money, and Ecuador would in all probability have been economically afloat again. Bailing-in official creditors, always demanded within an international Chapter 9, is therefore necessary.

Official creditors exerted massive influence on debtor economies, especially so as poor countries depend heavily on multilateral advice. As early as 1984 the IBRD (1984, p. 24) wrote that "external financial agencies have shared responsibility" for investments qualified as "genuine mistakes and misfortunes" without, however, calling for financial consequences. For decades the IBRD had been proud of its detailed monitoring of projects. Only recently this pride has not been shown as perceptibly. In the case of the IMF the Group of 24 criticised the proliferation of performance criteria extending quite often down to microeconomic variables such as prices for specific products. This difference vis-à-vis private creditors is well characterised by Svendsen's (1987, p.27) distinction between "debtor determined" and "creditor determined" debts. Commercial banks did lend aggressively but have usually not interfered with their clients' economic policy. IFIs have done so to the extent that countries do not see these operations as in their interest any longer - they do not "own" them. As debtors have to pay for IFI-errors this is hardly surprising. This victims-pays-principle is a unique arrangement, which cannot be justified by economic or legal reasoning (Raffer 1993). Under market conditions international firms do sue their consultants successfully in cases of wrong or negligent advice. Orange County sued Merill Lynch for $2 billion. Bank Austria sued Price Waterhouse for £147 million, arguing they had not checked Sovereign Leasing, a firm Bank Austria invested in, with sufficient care. Damage compensation is also awarded to private individuals in the Anglo-Saxon legal system if a bank goes beyond mere lending. A British couple borrowing money from Lloyds sued the bank successfully, because its manager had advised and encouraged them to renovate and sell a house at a profit. The High Court ruled that the manager should have pointed out the risks clearly and should have advised them to abandon the project. Because of its advice Lloyds had to pay damages when prices in the property market fell and the couple suffered a loss (*Financial Times*, 5 September 1995). With comparable standards regarding Southern debtors there would be no multilateral debt problem.

The exception of HIPC apart, multilateral institutions insist on full repayment, even refusing to reschedule. Even damages caused negligently by their staffs have to be paid for by borrowers that might get burdened with a further loan enabling them to repair the damage financed by the first. IFIs take economic decisions but refuse to participate in the risks involved. With IFIs decision making is not only delinked from financial responsibilities, their errors may even cause financial gains (Raffer 1993). This system is absurdly at odds with the any market system. The most basic precondition for the functioning of the market mechanism is that economic decisions must be accompanied by (co)responsibility. Whoever takes economic decisions must also carry financial risks. If this link is severed - as in the former Centrally Planned Economies - efficiency is severely disturbed. Bringing the market mechanism to IFIs is therefore mandatory. The striking contrast between free-market recommendations given by IFIs and their own protection from market forces must be abolished. The same percentage must be deducted from all debts. This is also a way to hold IFIs financially accountable. It is a matter of fairness to debtors as well as other creditors. Compensation for damages done within projects, where determining faults and errors is much easier has nothing to do with insolvency. An issue in its own right it would reduce the debt burden further (Raffer 1993; Raffer & Singer 1996, 2001).

IFIs argue that foregoing their "preferred creditor status" would deteriorate their own excellent rating as borrowers, increasing costs of lending. This argument is flawed. The IBRD simply refuses to acknowledge default, even if countries have not paid anything for six or seven years (Caufield 1998, p.319). Claiming no default as long as such countries stay "in mutual respectful contact" (*ibid.*), the IBRD mocks all acceptable accounting rules. If publicly known though officially denied defaults have not reduced its rating, properly acknowledged and handled default seems unlikely to do so. Apparently, guarantees by OECD governments rather than its own lending record account for the IBRD's rating. Finally, all multilateral development banks have loan loss reserves. A certain amount of lost loans is simply part and parcel of running banks, economically a necessary part. The possibility of losing money acts as an incentive for appropriate care. If the rating argument were true no commercial bank would have excellent ratings as none gets everything repaid as stipulated. Banking centres such as London's City or New York would be perceived as assemblies of credit risks.

Statutes of multilaterals foresee default. Article IV.6 of the IBRD's Articles of Agreement, e.g., demands a special reserve to cover what Article IV.7 calls "Methods of Meeting Liabilities of the Bank in Case of Defaults". To the extent necessary - if this reserve proves to be insufficient - "other reserves, surplus and capital available to the Bank" can be used. Appropriate amounts of unpaid subscriptions of members can be called. As the Bank is only allowed to lend either to members or if member states fully guarantee repayment (Article III.4) the logical conclusion is that sovereign default is definitely 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 and does not formally apply to the IBRD (Caufield 1998, p.323), its founders wanted the IBRD subject to market discipline rather than totally exempt from it. Mechanisms allowing the Bank to shoulder risks appropriately were designed. 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). The EBRD proves that IFIs can survive financial accountability and market risk if they are properly managed. Poor countries are usually soft window clients. Funds, such as IDA, can simply waive repayments without facing any economic problems. Only the IMF poses some difficulties. Initially, the IMF's Articles of Agreement did not allow conditionality, and the Fund's resources were only supposed to bridge short term problems of defending fixed parities. Unlike in the IBRD’s case no provisions for loan losses were therefore needed. When the IMF introduced conditionality, no appropriate changes regarding accountability were made. When the Fund started its massive operations as a debt manager this became particularly problematic. Introducing financial accountability for its own decisions is thus all the more important. Gold sales (revaluation) would be one way how the IMF could cover its losses under equal treatment.

Conclusion

HIPC II is again likely to produce insufficient results because of creditor power, prolonging the debt problem further. An orderly, fair and transparent process respecting human rights and the Rule of Law is needed - sovereign insolvency or FTAP is economically indicated. Civilised insolvency laws applicable to all debtors except developing countries demand neutral institutions assuring fair settlements. Creditors must not decide on their own claims - one must not be judge in one's own cause. Debtor protection has to be granted equally to all human beings.

Last but not least, an international Chapter 9 insolvency would also be an important part of a New International Architecture, providing incentives to lenders to make loans basically if repayments can be expected from proceeds. Debts which have to be serviced out of the budget should remain the exception, particularly so in very poor countries. Being sure to lose their money eventually, commercial lenders would stop lending if previous loans were not put to efficient use. Thus, if international insolvency had existed in the 1970s the debt burden would be much lower, maybe there would not even be any debt crisis. **The** amount of IFI-activities would strongly 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.

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