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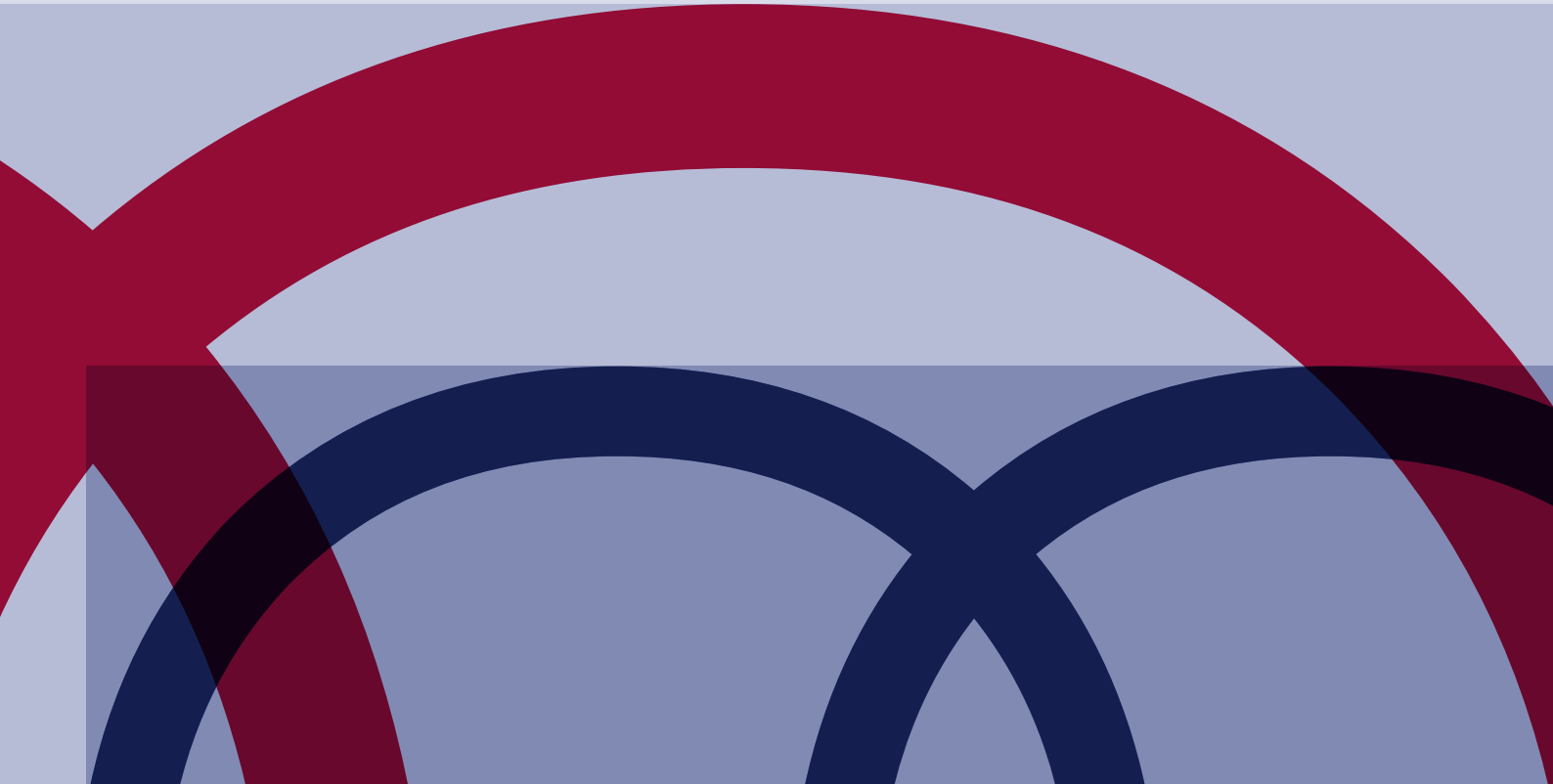
The evolving nature of developing country debt and solutions for change

By Bodo Ellmers • July 2016

A Eurodad discussion paper



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Executive summary

This Eurodad discussion paper is being published at a time when the impacts of the last global financial crisis that started almost ten years ago are still being felt in many countries. At the same time, a new debt crisis triggered by falling commodity prices and volatile capital flows has already hit some countries in the developing world.

The debt burden of developing countries has reached the highest level ever seen. When the Millennium Development Goals (MDGs) were adopted in 2000, developing countries faced the challenge of financing the implementation of these goals while carrying a US$1.4 trillion external debt burden. Now that the much more comprehensive and costly Sustainable Development Goals (SDGs) have been adopted, their financing competes with a debt burden owed by public and private debtors combined that has tripled to US$5.4 trillion. Debt service on this stock costs developing countries US$575 billion annually.

Most economies have grown substantially over the past 15 years, so the debt burden has decreased when measured as a share of national income or export revenue. This is in part due to debt relief initiatives that were put in place in the early years of MDG implementation, but no longer exist to back the SDG implementation. While relative debt burdens decreased between 2000 and 2010, these trends have reversed in 2011. Since then debt is on an upward path, also when measured in relative terms.

Most striking is the change in debt composition and debt instruments being used. Public debt in developing countries is increasingly being borrowed from private lenders. This has marginalised official lenders, especially the bilateral lenders whose share halved from 33% of the debt stock to 16% now. And private lenders have changed too: Bonds have replaced loans as a predominant form of private lending. At the same time, the share of bonds doubled from 21% to 42% of the debt stock. Since 2004, 23 new countries have started to issue bonds on financial markets. Domestic lending and borrowing is on the rise too, as is the provision of loans by new official creditors from emerging economies.

The evolving nature of debt implies that the new debt crises will be different from the last. A plethora of dispersed bondholders and investors have now started to lend to countries that could previously only receive credit from a handful of official and private banks. The old debt regime that the 2030 development agenda inherited has never been fully able put loans to work for development, to prevent debt crises, or to resolve them in a fair, speedy and sustainable manner. The bad news is: the situation is getting worse.

In an era when debt came predominantly from official creditors, there were some institutions that were developed specifically to deal with this issue, even though they were very slow, dominated by creditors and, as a result, created a lot of harm along the way.

Some lenders introduced safeguards to prevent harm – examples include the World Bank's safeguards or the International Monetary Fund (IMF)'s debt sustainability framework. However, these lenders are providing a decreasing share of finance. The main institution for debt crises resolution today is the Western bilateral official creditors' Paris Club, but this type of debt represents a decreasing share of total debt, and of the total contemporary debt problems too.

An increasing share of credit is not covered by any effective form of regulation. It falls into a regulation gap. The debt landscape has changed substantially while the modernisation of institutions to prevent and resolve debt crises has not kept up. The increasing number of creditors representing different types of debt means that a coordinated and comprehensive solution to debt crises becomes ever more difficult.

The evolving nature of debt requires up-to-date solutions for a development effective debt regime and for debt crisis prevention and resolution that must be able to reach the whole debt stock: public as well as private debt, external as well as domestic debt. The good news is: this is not news.

Substantial conceptual work has already been done on what a development effective debt regime for the 21st century could look like. Three regime-building processes on an international level stand out:

- To increase the development effectiveness of loans and to safeguard people and development from the damage that debt can do; the United Nations (UN) Human Rights Council has adopted the Guiding Principles on Debt and Human Rights.
- To increase the development effectiveness of loans and to prevent debt crises, the UN Conference on Trade and Development (UNCTAD) has designed the Principles on Promoting Responsible Lending and Borrowing, building on previous concepts developed by civil society organisations including Eurodad.
- To resolve debt crises in a fair, speedy and sustainable manner, several attempts have been made at both the IMF and the UN to create an insolvency regime for sovereign debtors. In other terms, a debt workout mechanism for states.

What mainly remains to be done is to overcome political deadlocks and put these proposals into practice. Regime-building is a cumbersome process. Depending on the political opportunities, innovations can happen either in the form of big bangs or in incremental steps, through international agreement or innovations at a national level that trickle up to the international level. In all of these cases, citizen action will have a key role to play.

Introduction

This Eurodad discussion paper analyses the evolving nature of developing country debt and solutions for change. The aim is to identify relevant reform processes on an international level, and more practically to keep progressive actors that want to drive change informed about existing opportunities.

The timeframe we will look at begins with the year 2000, when the Millennium Development Goals (MDGs) were adopted, to the present day as the international community takes on the challenge to implement the Sustainable Development Goals (SDGs). Understanding debt problems, so that debt crises can be prevented or at least resolved in a speedy and effective manner, is crucial in terms of achieving development goals.

Unresolved debt crises have caused lost decades for development for many developing regions in the 1980s and 1990s. MDG implementation made progress primarily in countries that had no significant debt problems in the early 2000s, such as China. That is why resolving debt problems through debt relief initiatives such as those for the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI) became a key pillar of the MDG framework. The SDG implementation cannot afford a lost decade for development, so effective institutions for debt crises prevention and resolution must be a central pillar of their means of implementation.

We distinguish between two different types of debt crisis. The first type of crisis is related to the risks of actual defaults – the risk that indebted countries cannot sustain debt service. This follows the narrow definition that the IMF uses when talking about debt distress. The second type is the crisis of public and development spending that is caused by rising debt service costs that are being sustained despite the development damage involved. Each Euro spent on debt service is a Euro lost for development and the progressive realisation of human rights. The risks of both crises occurring are severe.

This report complements earlier Eurodad research and valuable research carried out by Eurodad member organisations and partners from other regions, which have done tremendous work in recent years to monitor debt problems and analyse the new debt crisis risks.[1] This first part of this report contains a short summary of these risks, mainly those related to external and sovereign debt. The second part of the report considers the solutions.

Of course, one fundamental solution would be if governments and developing countries did not need to borrow at all to finance necessary expenses, but had sufficient revenues to avoid creating debt in the first place. This might include tax and tariff revenue, for example, or export revenue, the allocation of special drawing rights by the IMF, and development assistance grants. However, tax collection remains challenging in absence of effective institutions that could curb tax evasion and harmful tax competition. Richer countries continue to fail to meet the target of providing 0.7% of their Gross National Income (GNI) as development assistance, the IMF's mandate to issue Special Drawing Rights (SDRs) is restricted, and export revenue is highly fragile and vulnerable to shocks. Borrowing and lending acts and the debt that these create are therefore here to stay. This report avoids addressing larger public finance issues. It focuses instead on the debt regime: solutions to improving lending and borrowing policies, and to preventing and resolving debt crises.

The new debt landscape requires new solutions, and such solutions need to reach the whole debt stock. This discussion paper presents a number of key solutions in three central areas:

- First, to make loans development effective. This is key, as debt-creating forms of finance remain a relevant form of development finance besides tax revenue or official development assistance (ODA) grants.
- Second, solutions to preventing debt crises through more responsible lending and borrowing.
- Third, solutions to resolve debt crises in a fair, speedy and sustainable manner.

We are aware that the solutions we present are not exhaustive. Much more thinking and action is needed to break the political deadlocks that are currently preventing the necessary modernisation of the debt regime. This discussion paper serves primarily as input for the strategy discussions of civil society actors that want to drive such change forward.

Part 1 – The evolving nature of developing country debt

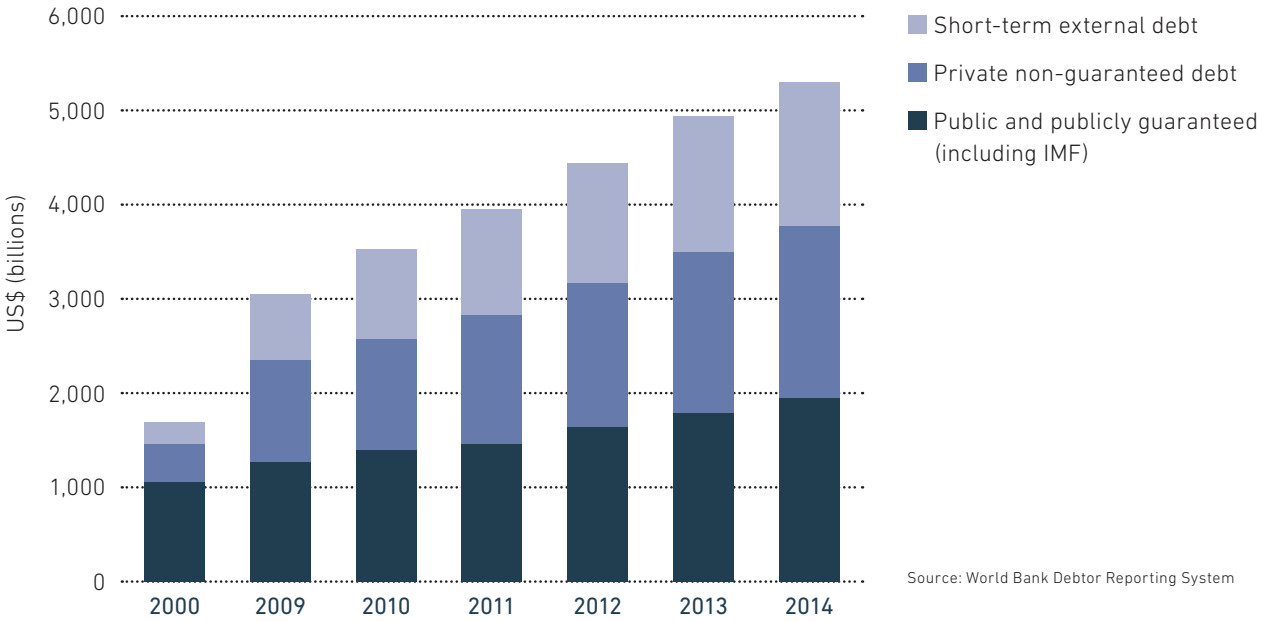
Comprehensive datasets of developing country debt are collated by the World Bank, in its International Debt Statistics. The World Bank data shows that the external debt of low- and middle-income countries has risen continuously over the past 15 years. In 2000, the year in which the MDGs started to be implemented, developing countries had to carry out an external debt burden of US$1.8 trillion. This surged to US$5.4 trillion in 2014. Thus, the SDGs are being implemented at a point when the external burden of developing countries has tripled. About half of this amount is now owed by private debtors in developing countries.[2]

Of course, the economies of developing countries have grown substantially over the past 15 years, and so has their capacity to sustain higher debt levels. While the external debt stock was 34.6% of GNI in 2000 (and 122.5% of export revenue), this fell to 19.8% in 2011 (or 67.0% of exports respectively). These improvements were made possible by exceptionally high economic growth rates, and also by debt relief initiatives benefitting many countries. The year 2011 was the turnaround year, however, when indicators changed their trajectory from getting better to getting worse. Since then, developing country debt has been on a continuous upward trajectory again, also when measured in terms of economic strength. Debt levels already reached 22.2% of GNI and 79.1% of export revenue in 2014.[3]

While future trends are hard to predict – even the IMF's forward-looking debt sustainability analysis have to be revised over and over to reflect the reality – recent changes in the macroeconomic environment suggest that things might become worse. UNCTAD identifies in particular the commodity price crash that came with the end of the commodity supercycle as a key risk factor. Most developing countries continue to be dependent on commodity exports, and only exports can generate the foreign revenue needed to pay off external debt. Falling prices mean less revenue.[4]

Another factor is that developing country currencies have depreciated compared to the US dollar. Even a constant US dollar debt load weighs more heavily when the dollar increases in value. This creates a policy dilemma. Developing countries could try to make their export industries more competitive by devaluating their currencies, but this would also increase the burden of external debt.[5] The option to solve debt problems through export-led growth is therefore not a viable option for many countries. External debt would need to be reduced to make a new growth cycle and economic upswing possible.

Figure 1: External debt stock of low and middle income countries 2000-2014



Source: World Bank Debtor Reporting System

Remarkably, the private sector has replaced the public sector as lead borrower, playing a major role in the new borrowing and lending boom that has taken place over the past 15 years. This in turn is a consequence of the fact that public borrowing in the age of neoliberalism is strongly supervised and regulated in most countries, by national institutions and 'fiscal responsibility laws', and by external bodies such as the IMF. Private borrowing, on the other hand, is not. UNCTAD provides the following analysis: "*Oversight bodies tended to be influenced by free market advocates who opposed Government intervention in growing private external liabilities.*"[6]

Private borrowers have used this regulation gap to celebrate a big borrowing party, a debt party, and thus contributed disproportionately to the external debt burden that developing countries carry now. External lenders are jointly responsible, as their provision of loans has made this party possible. Private lenders have sought presumably lucrative investment opportunities in the global south. Even public loans have been increasingly channelled to private companies and banks, through Development Finance Institutions (DFIs) such as the International Finance Corporation (IFC) and bilateral sister organisations.[7] Private debt can become a contingent liability for the state, through explicit or implicit guarantees. Future solutions to developing country debt crises must therefore tackle problems related to private debt too.

Most developing countries still manage to sustain their debt burden, but the costs of doing so have become an enormous drain on resources. Annual debt service on external debt has risen to US$575 billion, about four times the amount that is reported as official development assistance (ODA). The first developing country debt crisis is therefore the crisis of opportunity costs. Each dollar that is transferred to creditors abroad is a dollar that goes missing to finance the implementation of the SDGs at home.

Chapter 2: The risk of new debt crises

The borrowing boom of the last decade was possible because access to credit was easy for developing countries. High growth rates coupled with high prices for their main export products made them look creditworthy and created good investment destinations. At the same time, credit supply was abundant, because central banks in the crisis-ridden global north created a lot of extra money, which could not be invested in the north because austerity policies stopped northern governments from borrowing. Their already overleveraged private sectors did not absorb this credit either in times of economic stagnation, so it went to developing countries. South-south lending also constituted an emerging source of debt, in particular because China was looking for lucrative investment opportunities.

Since 2014, however, new credit to developing countries has slowed down. According to World Bank figures, net debt inflows to developing countries fell by almost US$100 billion in 2014, down to US$463 billion. This happened although net lending by official creditors has doubled since the previous year. So it is entirely private creditors that have reduced lending. Anecdotal evidence for 2015 shows that this is a continuing trend.[8]

On the one hand, this fall is good news. It means that the debt build up in developing countries is slowing down. Developing countries are no longer indebting themselves as quickly and deeply as before. However, this may not be because they do not want to borrow more, but because they cannot borrow more.

Debt sustainability – understood here as the risk that a debtor defaults – is not so much dependent on objective indicators such as the debt-to-GNI or the debt-to-exports ratio. Defaults usually happen when it becomes impossible for the debtor to rollover existing debt stock, when it becomes impossible to find new creditors that are willing to lend and refinance old debts that mature. The slowdown in new lending may well therefore imply, on the other hand, that access to credit is becoming more difficult for developing countries. A credit crunch at these elevated debt levels would make substantial debt restructuring necessary in a large number of developing countries.[9]

The second developing country debt crisis is therefore the crisis of actual defaults. The risk that they can no longer sustain and refinance the massive debt burden that has been built up over the last decade. Such debt crises are economically distortive. They trigger economic recessions and rising unemployment as well as reducing tax and other public income, so that public service provision becomes difficult to fund.

While debt service in normal times is already a constraint for putting money to use for development financing, such a round of new 'default-type' debt crises will be a development disaster. At the 2016 UN Financing for Development Forum, the President of UNCTAD's Trade and Development Board warned: *"Sovereign debt crises can set back economic and social progress by a decade or more, and hinder the ability of governments to engage in the types of economic and social investments necessary for sustainable development. Their recurrence would put an end to the SDG timeline before it had even begun."*[10]

Chapter 3: New debt crises will be different from the last ones

The risk of debt crises occurring is increasing. This is not just the risks related to external debts, but also those related to sovereign debts (composed of external and domestic debts) and private debts in general. The most recent Global Sovereign Indebtedness Monitor by Erlassjahr.de found critical debt problems of different sorts in 108 developing countries and emerging economies. It also confirmed that the situation overall is deteriorating, that trends are going downwards: The assessment along six different debt indicators for the whole country group found 234 negative changes, and just 127 positive changes. Most negative developments can be observed in the area of sovereign debt. The Middle East and North Africa (MENA) region and Latin America were the regions with most negative changes in the last year, while the Eastern Europe and Central Asia region had the most severe debt problems overall.[11]

The debt composition of and use of debt instruments by developing countries and their lenders have changed substantially over the past decade. This primarily poses new challenges to the existing regimes for debt management and debt crisis management that has been built to tackle the old crises. What are the significant trends?

The boom in bond issuances

One remarkable trend is that more and more countries have started to borrow by issuing bonds on international financial markets. According to a recent IMF mapping exercise, 23 additional countries started to use bonds for the time, and were first-time issuers since 2004.[12] The World Bank adds that the share of developing countries' external debt that is in form of sovereign bonds reached 42% in 2014.[13] Bonds thus started to replace traditional forms of bank loans and (concessional) official loans for many countries.

It is remarkable that the trend towards bonds has also reached lower middle income countries and even low income countries such as Rwanda and Tanzania. Low-income countries used to have a very different debt structure than middle-income countries: usually higher shares of external than domestic debt, and a higher share of official as compared to private loans. This is statistically still the case but, due to the boom in bond issuances, the trend is that the debt structure in low-income countries becomes more similar to those in middle-income countries. And so do the debt problems.

Figure 2: Debt levels and trends by region

Overview by region

Explanation		Asia		Sub-Saharan Africa		Latin America & Caribbean		North Africa / Middle East		Europe / CIS	
high debt levels but positive trend	high debt levels and negative trend	1	5	1	5	4	7	1	1	4	7
low debt levels and positive trend	low debt levels but negative trend	11	6	15	15	5	9	0	4	4	3

Source: Erlassjahr Global Sovereign Indebtedness Monitor

Table 1: First-time bond issuances in developing countries 2004-2013

Country	Issue Year	Nominal GDP (US$bn)	GDP per capita (US$ PPP 2005)	Size ($mn)	Size (% of GDP)	Tenor (years)
Albania	2010	12.7	8,059	407	3.2	5
Armenia	2013	10.1	5,727	700	7.0	7
Belarus	2010	63.3	13,427	600	0.9	5
Bolivia	2012	27.4	4,552	500	1.8	10
Ecuador	2005	80.9	8,393	650	0.8	10
Gabon	2007	18.4	13,864	1,000	5.4	10
Georgia	2008	15.9	5,086	500	3.1	5
Ghana	2007	38.9	1,764	750	1.9	10
Honduras	2013	18.4	3,614	500	2.7	10
Jordan	2010	31.2	5,298	750	2.4	5
Mongolia	2012	10.3	4,708	1,500	14.6	10
Montenegro	2010	4.3	10,711	254	5.9	5
Namibia	2011	12.3	6,453	500	4.1	10
Nigeria	2011	268.7	2,294	500	0.2	10
Pakistan	2004	231.9	2,491	500	0.2	5
Paraguay	2013	26.0	5,290	500	1.9	10
Rwanda	2013	7.2	1,167	400	5.5	10
Senegal	2009	13.9	1,675	200	1.4	5
Seychelles	2006	1.0	23,277	200	19.4	5
Sri Lanka	2007	59.4	5,384	500	0.8	5
Tanzania	2013	28.2	1,380	600	2.1	5
Vietnam	2005	138.1	3,133	750	0.5	10
Zambia	2012	20.5	1,475	750	3.7	10

Source: IMF based on Bloomberg and Dealogic data

The bonds boom has severe consequences for debt crisis management. First, bonds are usually far more expensive than (concessional) official loans. Some countries such as Ghana or Senegal pay more than 8% interest annually on their bonds. So debt service is much more costly, and a much smaller stock of bonded debt should be considered sustainable. Second, many of the bond issues have been very voluminous. The 2006 issue by Seychelles accounted for 22% of Gross Domestic Product (GDP), while the Mongolian bonds issue of 2012 accounted for 30% of the country's entire debt stock.

There is a maturity concentration when such bonds fall due, and there is no reason to be sure that investors will make sufficient money available to refinance these bonds when they mature. So there is a considerable rollover risk and thus default risks. Seychelles could not even sustain debt service until maturity, the country defaulted two years after issuance and had to restructure in 2009.[14]

Restructuring bonds is not easy: Countries that have mainly official creditors and banks as creditors can negotiate with a limited number of creditors when it turns out that they have to restructure their debts. This does not mean that these creditors quickly agree on a debt restructuring deal when needed, but at least procedurally it is manageable. This is because usually these creditors are more or less well coordinated by the Paris Club in the case of official creditors, or by the London Club in the case of banks.

This is not the case when it comes to bonds. Bondholders can be made up from thousands of different investors. They are dispersed, and no permanent body exists to coordinate negotiations with them. Often sovereigns do not even know who the bondholders are, because there are no public bondholder registries, and bonds can be traded within seconds on secondary markets. There is always the risk that there are some holdouts – groups of bondholders that do not accept a debt restructuring agreement.

Even worse, because bonds are so difficult to restructure, a group of predatory investors has emerged that aims to make exorbitant profits by speculating on crisis states' bonds – the so-called 'vulture funds'. Vulture funds buy the junk bonds of crisis-ridden countries from holdout creditors on secondary markets, at prices that are usually far below the nominal value. Eventually they refuse to participate in debt restructuring negotiations and instead sue for full payment. This both delays a sustainable solution to the debt crisis, and makes it far more expensive.

Insolvencies related to bonded debt are not new. In the case of corporate debts, restructurings are regulated by corporate insolvency laws and handled by insolvency courts. No equivalent framework exists over for sovereign insolvencies and sovereign bonds. An up-to-date framework to solve debt crises would therefore require institutions that make fair, speedy and sustainable bond restructurings possible.

Another issue when finance comes in the form of bonds is that it also becomes difficult to hold creditors to account. In response to civil society pressure, multilateral and bilateral development banks have developed important – if imperfect – 'safeguards' to prevent human rights violations or harmful social and environmental impacts. Private banks are also concerned about reputational risks, and many have signed up to voluntary standards such as the Equator Principles.[15] Compliance has never been easy to ensure, and non-compliance remains difficult to sanction, but a certain responsible finance framework exists. Bondholders in contrast are anonymous, and money raised through bonds is even more fungible than project loans, meaning that it is impossible to track which activity is funded by which bond.

Ensuring the development effectiveness of bonded debt is a major challenge, and regulation is still in an infant stage. UNCTAD has identified the problem and developed the Principles for Promoting Responsible Sovereign Lending and Borrowing (see chapter 8 below). But these still need to enter into force in order to prevent misuse and misconduct related to bonded debt.

The trend towards domestic debt

A second boom has been seen in domestic debt,[16] which increasingly complements borrowing by external sources. Financial markets in more and more developing countries have reached such a depth that borrowing from domestic sources is possible. This sort of debt replaces external loans from foreign creditors, such as for instance the World Bank, which have lost their oligopoly on providing credit. This is a good development. Domestic debt can be more expensive in terms of the interest rate paid, but at least the debt service stays in their own economy and accumulates capital there, while debt service on external debt flows out to foreign investors. Additional advantages include the fact that debtors do not need to generate foreign currency revenue to pay down domestic currency debt. And when debt instruments are issued under domestic law, sovereign debtors have more means at hand to restructure when needed.[17]

There is, however, one crucial caveat. Large amounts of domestic debt are usually held by the banking system of the debtor country concerned. For these banks, it is part of the asset side of their balance sheets. If domestic debt becomes unsustainable and needs to be restructured, these banks will face substantial losses. If the haircuts on domestic debt are large, this can reach such an extent that the banks themselves become insolvent. Thus, the banks either need to be shut down, with severe consequences for the whole economy of the country concerned – including the affected banks' depositors whose savings would be lost. Or the government can recapitalise these banks. However, this is obviously difficult to do when the sovereign itself is bankrupt, which was the reason for the debt restructuring in the first place.

This sovereign-bank nexus is well-known from the last financial crisis in Europe, but also from the Southeast-Asian crisis in the late 1990s. The policy choice in these cases was to bail out the banks through large injections of money from external creditors, such as the IMF or in Europe the European Stability Mechanism. Thus, formerly domestic debt held by private creditors was moved to the balance sheets of external public creditors. After the experience of the Eurocrisis, the European Union (EU) also tried to break the sovereign-bank-nexus by establishing a framework for the recovery and resolution of credit institutions and investment firms.[18] The framework intends to create a self-insurance mechanism for banks, so the costs for failed banks are borne by the financial sector itself. A lesson from debt crises that contain large shares of domestic debts is that part of the solution is to have necessary firewalls in place to break the nexus between sovereigns and banks.

Obviously, domestic debt is not covered by World Bank or other official creditors' safeguards either. Ensuring development effectiveness and compliance with human rights or social and environmental standards therefore requires adequate national regulation in place in all developing countries. The UNCTAD Principles also give guidance to sovereign borrowers and their domestic lenders about what these can look like.

The trend towards off-balance sheet debt: Public-private partnerships

Last but not least, there is much more quasi-sovereign debt out there than the official data suggests. Governments increasingly use public-private partnerships (PPPs) to finance infrastructure projects and other public projects that have traditionally been financed through the current budget. These PPPs cause debt-like liabilities for governments, because governments have given different sorts of guarantees to the private investors which – with a likelihood that is difficult to calculate – may become active in the future.

The trend towards PPPs is on the one hand driven by neoliberal ideology ('the private sector can do it better'), and by lobby pressure from private corporations and consultancy firms, but also by the legal and institutional framework nationally and internationally. For instance, the IMF debt limits policy and the joint IMF-World Bank Debt Sustainability Framework constrain how much governments can borrow. Developing countries respond by funding investments through PPPs that are off-balance sheet. Curiously, the IFC and other multilateral development banks (MDBs) are facilitating this reaction through funding and policy advice.[19] Moreover, many countries have put national restrictions on fiscal deficits in place (similar to the EU's debt limit in the Annex to the Maastricht Treaty), or ministers want to suggest to the public that their budget was fiscally prudent, while in fact they are creating future liabilities.

PPPs allow governments to implement additional projects while costs do not appear in the current budget. They are off-balance sheet, so they can be used to side-line legal or quasi-legal debt limits. They are hiding the true debt picture. However, of course they do have costs in the future. In most cases, PPPs are actually much more expensive than traditional ways of infrastructure and public service provision.

Global data is not available, but analysis for the UK, a frontrunner when it comes to the use of PPPs, found that the UK government wasted GBP£200 billion between 1990 and 2013 by preferring PPPs over other financing and procurement options.[20] In 2011 a review by the UK Parliament's Treasury Committee found that the use of PPPs through the Private Finance Initiative (PFI) "*has the effect of increasing the cost of finance for public investments relative to what would be available to the government if it borrowed on its own account*".[21] A 2015 review by the UK National Audit Office found that investment through PFI schemes cost more than double what it would cost if the government had borrowed directly,[22] and this does not include the cost of paying private companies profit under PFI. Doing so would mean that PFI would be even more costly than direct public borrowing and investment.

Case studies such as those by Oxfam on a hospital in Lesotho came to shocking conclusions: A new PPP-hospital turned out to be three times more expensive than the old one it replaced, while the investors get a guaranteed return of 25% annually on their investment. And the IFC, which brokered the deal, cashed in a huge commission of US$720,000 for their advice.[23]

Currently, incentive structures are organised so that governments choose PPPs over other options. A simple solution is to create more transparency and to unveil the true costs of PPPs. Also, debt policies need to be reformed to include PPP liabilities, so that off-balance sheet financing is no longer used when it is disadvantageous. The IMF started to work on these issues. In addition, the UN, in the recent Addis Ababa Action Agenda on Financing for Development, suggested agreeing on development-focused principles and criteria for the use and assessment of PPPs.

Chapter 4: Implications for debt crisis management

Debt crisis prevention did not work: shortcomings of the current regime

The regime to prevent and manage sovereign debt crises has never worked very well. Since the 1950s, there have been more than 600 cases where sovereign debt became unsustainable and had to be restructured, the vast majority in developing countries.[24] Debt crisis prevention obviously failed. And this is not just when avoiding debt crises is defined as avoiding defaults, but also when it is defined as avoiding recessions and impoverishment.

Development needs and human rights have been neglected

There should have been even more or earlier debt restructurings. A fundamental problem from a human-rights and development perspective is that governments in many cases continue to pay down debts – and creditors and international finance institutions (IFIs) pushed them to – when the implication is that they no longer have the necessary resources needed to finance development and the provision of essential public services. Jeffrey Sachs once criticised the debt sustainability definition used by IMF and World Bank: "*It is perfectly possible, and indeed is currently the case, for a country or region to have a 'sustainable' debt (and significant debt servicing) under these formal definitions while millions of its people are dying of hunger or disease.*"[25] The regime in place was never fully able to conduct debt crisis prevention and management under a development or human-rights perspective, including the right to development. To ensure this, the financing needs of human rights provision would need to become a trigger criteria for initiating debt restructurings – ensuring the primacy of human rights over debt service.

Responsible lending and borrowing is not secured

Another reason why debt crisis prevention does not work is that neither sovereign lenders nor borrowers make fully responsible credit decisions. Independent watchdogs and debt audit campaigns have identified numerous cases of illegitimate debt – the result of irresponsible lending and/or borrowing.[26] There is also no effective legal or institutional framework in place to ensure that they do.

Existing regulation is one-sided, and limited to debt quantity

There are some regulations that target the *quantity of borrowing*. Prominent examples are the IMF debt limits policy, or in Europe the Maastricht criteria (the Annex to the Maastricht Treaty), which determine that fiscal deficits should not exceed 3%, and sovereign debt stocks should not exceed 60% of GNI. Some countries have national legislation in place to restrict borrowing, often called 'fiscal responsibility laws'.

There are no similar regulations that restrict the *quantity of lending,* however. The sole exception is the Joint IMF-WB Debt Sustainability Framework that influences financing decisions by the World Bank (WB). Countries that are at high risk of debt distress, or in debt distress, are supposed to receive only grants by the World Bank's International Development Association, to ensure that their debt problems do not get worse.[27] The World Bank hopes that other lenders follow this policy too, but has no means to ensure this.

Generally, while there are always two parties to a debt contract – it takes two to tango, a borrower cannot borrow if no lender is willing to lend – the burden to prevent debt crises is borne by the borrower side. The principle of co-responsibility to prevent and resolve debt crisis has been acknowledged politically, among others, by the UN's Monterrey Consensus on Financing for Development, which states: "*Debtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations*."[28] But this has never been fully operationalised.

The lack of a legal and institutional framework for responsible finance is even more severe when it comes to the *quality of lending and borrowing*. Theoretically, if loans are spent well, the quantity of lending and borrowing should not matter much. Even large amounts of debt can be sustained if loans are used productively and responsibly, if they generate a financial return higher than their interest rate.[29]

The problem is, in practice loans are often not used productively and responsibly. Issues on the lender side include that they tend to attach harmful conditions to loans that increases borrower countries' vulnerability to debt crises, or they tie them to the purchase of overpriced and useless products. On the borrower side, corruption can divert resources, borrowed money can be used for funding short-sighted political interests, or spent on useless white elephant projects that do not yield the return needed to sustain debt service.

The result is that many loans create illegitimate debts. Irresponsible lending and borrowing and the illegitimate debts it creates constitute a major risks for debt crises. If all borrowers and lenders acted responsibly, many debt crises could be avoided.

Attempts to address this problem have been made. There is no lack of 'Principles' or 'Standards' that define how responsible finance that does not create illegitimate debts should look. Prominent examples are UNCTAD's Principles on Promoting Responsible Lending and Borrowing, but also sets developed by civil society organisations (CSOs), such as Eurodad's Responsible Finance Charter, or Afrodad's Borrowing Charter.[30] The problem here is that none of these Principles have been translated into codified law and nor are they binding and enforceable, which is why in practice they are rarely followed.

Some of these Principles, for instance those by UNCTAD, also give guidance on how borrowers and lenders should act and react in debt crisis resolution.

Debt crisis resolution did not work either

The fact that debt has had to be restructured in about 600 cases since the 1950s – that is three times more cases than countries on this planet – also highlights another problem. Debt crisis resolution has never been sustainable. Many countries are 'serial restructurers'. The solution to their last debt overhang was insufficient to stop the problem from reoccurring just a short time later. And here it does not matter if a country's debt problem is related to borrowing from official or private sources. An IMF analysis found serial defaults and restructuring related to loans from private sources – drastic cases include eight times in Poland, seven times in Jamaica and six times in Ecuador and Brazil between 1978 and 2010.[31] Senegal's official debt has been treated 14 times at the Paris Club between 1981 and 2004, when substantial debt relief under the HIPC initiative finally provided a somewhat sustainable solution.[32]

The central problem here remains that no insolvency regime exists that would cover sovereign debtors. For corporate insolvencies and private insolvencies, there are specialised insolvency courts that can make binding and enforceable decisions, and codified insolvency laws that guide this decision-making. Insolvency laws for private individuals usually protect the basic needs of the indebted person. Sovereign debt crises in turn are tackled by a fragmented and ad hoc 'non-regime', in which decision-making is arbitrary, creditor-specific and creditor-driven.

Forum fragmentation: Institutions for independent decisions and comprehensive treatment are missing

The Paris Club remains key for institutions of this regime. It is an informal assembly of Western bilateral creditors that is convened by the French Ministry of Finance when needed. The Paris Club tackles bilateral loans of its members only, which include not even all bilateral creditors.[33] The Paris Club is able to grant relatively generous debt reliefs, including large haircuts on the principal amount owed. There are, however, no fixed rules about who would benefit from debt relief, and when, and to what extent. This means that, in practice, Paris Club debt reliefs are a rather arbitrary and political affair.

The Paris Club expects "comparability of treatment" from other creditors, meaning that all creditors should reduce their claims to the same extent as Paris Club creditors do. However, it is not uncommon that the other creditors do not comply – why would they since they do not have a say in Paris Club decisions? – and the Paris Club cannot enforce compliance.

The Paris Club proudly boasts on its website that it has negotiated 433 agreements since its founding. This should rather be seen as evidence for the ineffectiveness of its operations that lead to the need for serial restructurings. And also as evidence that giving financial assistance to developing countries as loans instead of grants was perhaps a bad idea in the first place, and probably did more harm than good.[34]

Then there is the London Club, an informal body coordinating banks when private bank loans to a certain country became unsustainable and need to be restructured. The London Club is usually convened by the bank that is the largest creditor. Similarly to the Paris Club, the London Club does not apply fixed rules for the who, when and how of debt relief, and cannot enforce decisions on all creditors. The London Club has not been very active in recent years, partly because bank loans have played a decreasing role, as bonds became the dominant form of private lending to developing countries.

Of course, there is the IMF, which is strictly speaking not directly involved in debt restructurings. The IMF insists that its own loans cannot be restructured, that it has preferred creditor status. This means that IMF loans are usually exempted from restructurings. The few exceptions are country- or situation-specific. For example, the Multilateral Debt Relief Initiative of 2005, or more recently the Catastrophe Containment and Relief Trust.[35]

However, the IMF plays an important role when it comes to initiating debt restructurings. The IMF's lending framework foresees that the IMF cannot lend to a country that is actually insolvent. If an IMF-led debt sustainability analysis finds that it is insolvent, IMF lending comes with the condition that the existing debt stock is reduced, which is in many cases the actual trigger for an overdue debt restructuring process. Although this is the official rule, the reality is different. De facto IMF lending decisions are made by the IMF board on the basis of political considerations and/or vested interests. IMF does in fact lend to insolvent states without requiring an upfront debt restructuring. Prominent cases recently include Greece and Ukraine.[36]

Even the rules of the IMF lending framework have recently been relaxed. An interim option, the so-called debt reprofiling, has been introduced, meaning that it is sufficient to change the payment terms of existing debt in situations where debt is assessed as sustainable "with a high probability".[37] IMF debt sustainability analyses follow a sophisticated methodology. Still, they often turn out to be too positive, meaning that too little debt is relieved because too large debt stocks are considered sustainable. In any case, even the IMF has no power to make binding decisions and enforce all creditors' participation in unavoidable debt restructurings. Participation is voluntary and holdouts of both private and official creditors are common.

For the treatment of bonds, there are no structures or standing bodies at all: Bondholders can form creditor committees to negotiate debt restructurings but – since bondholder participation in debt restructurings under the current regime remains voluntary – so is the participation in creditor committees. Consequently, no creditor committee represents all bondholders, or can enforce decisions on all bondholders.[38] Much work has been done recently to facilitate collective decision-making by bondholders. The IMF and the International Capital Market Association (ICMA) have developed ever more comprehensive collective action clauses. They suggest that sovereigns that issue bonds should add these to their new bond contracts so that a minority cannot hold out against the will of a supermajority of bondholders.[39] Vulture funds, however, do find innovative ways to move around such constraints. And anyway, the so-called collective action problems do not just appear within one type of debt (such as bonds), but between creditors representing different types (such as bilateral and private creditors). While bonds represent an increasing share of developing countries debt stock, they are just one share. A comprehensive debt crisis solution would require debt restructuring frameworks that reach all shares.

Speedy solutions are impossible

The consequence of the forum fragmentation described above is that it is currently impossible for an insolvent state to restructure all debts in one single comprehensive process. Different types of debt have to be negotiated with different creditors in different fora. This can take a long time: Trebesch et al estimate that on average it takes 32 months to restructure bank loans, and 13 months to restructure bonds. This timespan can increase massively if different types of debt are involved that have to be renegotiated in different forums and/or if holdout creditors and vulture funds start to litigate against the debtor. The resolution of the Peruvian debt crisis of 1983 lasted for 14 years until 1997. The resolution of the Argentine debt crisis of 2001 is still not fully done, 15 years later. During this period, unresolved debt problems have caused substantial damage to the economic and social fabric of affected nations and their populations.[40] The current non-regime is incapable of solving debt crises in a speedy manner.

Fair burden-sharing is not guaranteed

This also makes it nearly impossible to ensure fair treatment between different creditor groups. It is unlikely that a comparable agreement will be negotiated with all groups when this is done in a consecutive manner. The non-regime creates a first-mover problem, an incentive for creditors to hold out. The first group of creditors that agrees on debt relief already partly restores a crisis country's solvency. The following groups can eventually insists that less or no further relief is necessary.

A striking example here is the Argentine debt crisis of 2001/02: Creditors who participated in the 2005 debt restructuring wrote off a substantial share of their investment. The bilateral Paris Club creditors who negotiated an agreement with Argentina in 2014 are being paid in full.[41] And some vulture funds, which had bought up defaulted bonds at bargain prices and sued the country at New York courts, even managed to make more than 1,000% profit on their investment when Argentina finally relented in 2016.[42]

Illegitimate lending goes unpunished

A general problem is that none of these forums makes a distinction between illegitimate and legitimate debts. This also leads to unfair treatment, because it can be assumed that, in many cases, it was the irresponsible share of lending that caused the debt crisis. Due to the lack of distinction, irresponsible and responsible lenders tend to take the same haircut, have to write off the same share of their debt, when they are in the same debt category. This implies that the responsible lenders participate in a burden sharing, and the irresponsible lenders can free-ride on the back of this. A debt restructuring operation should therefore always come with an independent debt audit, or a validation of claims.

Basic needs and human rights are not ring-fenced

Last but not least, a key problem remains that financial indicators (such as debt-to-GDP or export revenue ratios) are the key determinants for decision-making. The protection of basic needs for the population, and the financial implications this has, play no relevant role in determining how much debt needs to be relieved, and at what point to trigger a debt relief operation. While private insolvency law protects indebted individuals from 'paying themselves to death', there is no such protection for sovereign debtors, who can be pressed to continue debt service even when this puts the lives of the country's own people at stake.

Chapter 5: The new landscape makes debt crisis prevention and resolution even more difficult

The current 'non-regime' for the prevention and resolution of debt crises already has substantial shortcomings. However, the new debt trends outlined above mean that it is likely to become even less effective in the future. Ever larger shares of the debt stock are not covered by any forum. The official loans of new bilateral creditors such as China, Brazil or the Persian Gulf States are not being treated by the Paris Club. The Multilateral Debt Relief Initiative – which was set up in 2005 to restructure loans from World Bank, IMF and others when needed – has expired, and no further country can qualify. This means that there is currently no mechanism at all in place to restructure multilateral loans.

The surge in domestic debt implies that governments of developing countries, even low-income countries, are similarly held hostage by the sovereign-bank nexus as European countries were when the financial crisis started in 2008. And it might soon turn out that their firewalls to protect themselves from the insolvencies by private banks or other heavily indebted private borrowers might be even less effective.

The fact that the creditor landscape is becoming ever more diverse and dispersed also makes accountability and watchdog work much more difficult. While in the past such work could mainly focus on the World Bank and a few other official creditors, there is now a plethora of different creditors and investors that provide loans to developing countries. Safeguards that bind only one creditor therefore cover a decreasing share of available finance, and 'dodgy borrowers' can easily sideline them by sourcing credit from uncovered creditors. In the light of such a dispersed creditor landscape, the scope of future accountability mechanisms must therefore focus on borrowing and lending policies as a whole.

Due to the bond boom in recent years in which many new countries have started to use this debt instrument, defaults on bonds will play a key role in the next debt crises in many low- and lower middle-income countries too, for the first time in this country group's history. The appearance of ever more aggressive vulture funds will make future bond restructurings based on voluntary creditor participation ever more difficult.

The fact that PPPs now constitute a new form of off-balance sheet debt of relevant weight will pose additional challenges. There is no reason to think that private investors involved in PPPs will be easy to convince when it comes to renegotiating PPP contracts, should this become necessary. Similarly to vulture funds, the litigation strategy is often a preferred choice. Here it is not just the absence of a legal framework for sovereign insolvencies that makes a solution difficult, PPP investors can point at bilateral investment treaties and their investor-to-state dispute settlement clauses to litigate against states.[43] The design of PPP contracts continues to turn a blind eye to the risk of sovereign insolvencies and the eventual need of debt workouts.

Without major reforms, the next round of developing country debt crises will be even more difficult to manage and resolve than the last.

Part 2 – Ending debt crises: Towards effective prevention and resolution

The old and new challenges for preventing and resolving debt crises in a fair, speedy and sustainable manner require substantial reforms. There is no need to start from scratch: Most problems and potential solutions are already known, and many relevant reform processes have already been initiated. However, some regime-building processes face political blockades, while other reforms have become stuck along the way from policy formulation to actual implementation.

The second part of this discussion paper presents some of the key solutions to creating a regime for debt crisis prevention and solutions that make sure finance serves people and their development, and not the other way around. Debt problems are complex and therefore there are no simple solutions.

However, three key and overarching problems stand out:

- First, the need to put debt in context, to clarify the role that debt obligations play vis-à-vis development and the progressive realisation of human rights.
- Second, the need to prevent debt crises through effective regulation that ensures responsible lending and borrowing.
- Third, to finally create an insolvency or a debt workout mechanism for sovereigns that can resolve debt crises in a fair, speedy and sustainable manner.

This section of the report looks at these issues in more detail.

Chapter 6: Putting people first: Ensuring the primacy of human rights over debt service

Sovereign lending and borrowing should ensure that governments can do more for their people and their nation's development, just as they would if they relied on non-debt creating finance such as tax revenue or ODA grants. In practice, however, the 'debt regime' too often does not work that way. A badly designed debt regime hinders development and public service provision, instead of promoting it.

Net outflows on debt in heavily indebted countries in particular are a major constraint. Each dollar or euro that is spent on debt service is not spent on public service provision or productive investments. Cephas Lumina, the former UN Independent Expert on debt and human rights, laments that "*the fulfilment of debt service obligations is often undertaken at the expense of social investment, including investment in services that contribute to the realization of human rights*".[44]

In times of acute debt crisis, when heavily indebted countries cede their sovereignty to creditor institutions in search of bailout loans, creditor conditionality makes things even worse. Eurodad found numerous examples of harmful and anti-developmental creditor conditionality that was imposed on indebted countries in a desperate attempt to free up money to continue debt service, at the population's expense.[45]

The Greek case is a recent and tangible example, as data quality here is particularly good. An assessment carried out in 2015 by Juan-Pablo Bohoslavsky, the current UN Independent Expert on debt and human rights, found massive public spending cuts following creditor demands. General government expenditure fell by 15.7%. But even worse, the spending items most relevant to ensuring well-being and human rights of the poorest and most vulnerable people were cut disproportionately. Health spending fell by 42.5%, sickness and disability spending fell by 32.6% and unemployment spending fell by 29.8% over a period when the unemployment ratio had tripled. While these cuts were taking place, public monies were reallocated to finance bank bailouts. This points to the fact that spending related to human rights and essential services suffers in times of crisis, due to a combination of general public spending cuts, and regressive reallocations towards spending items that benefit richer people, primarily bank bailouts.

Table 2: Austerity measures and bank bailouts in a debt crisis: The example of Greece

General government expenditure in €million	2009	2010	2011	2012	2013	change
Total general government expenditure	128,150	117,774	111,633	104,491	108,009	-15.7%
General public services	28,365	27,590	26,672	20,796	17,645	-37.8%
Social protection	44,473	42,908	42,422	39,799	34,997	-21.3%
Old age	30,794	30,516	30,218	29,731	26,274	-14.7%
Sickness and disability	3,974	3,919	3,682	3,435	2,680	-32.6%
Unemployment	2,377	2,266	3,241	1,840	1,668	-29.8%
Health	16,089	15,393	13,314	11,079	9,249	-42.5%
Education	9,636	9,007	9,164	8,607	8,189	-15.0%
Housing and community amenities	884	446	384	416	514	-41.9%
Defence	8,167	5,768	4,960	4,607	3,881	-52.5%
Economic affairs (mainly bank bailout costs)	12,735	9,805	8,398	12,987	27,535	116.2%

Source: UN Independent Expert based on Eurostat data

A general principle in national and international law is *pacta sunt servanda* (agreement must be kept). However, governments' financial resources are often insufficient to keep all agreements, which might include loan contracts with creditors, pension obligations towards retired employers and national or international human rights obligations in the areas of education and human rights. Under the current debt regime, human rights agreements are often subordinated to ordinary loan contracts, as governments choose to allocate scarce revenues towards debt service. This is not necessarily done with the informed permission of the citizens whose tax payments generate that revenue. Some countries in debt distress have even changed their constitution towards prioritising debt service, in order to secure 'creditor confidence'.[46]

The UN Guiding Principles on Debt and Human Rights attempt to challenge such trends and put people over debt service. These Guiding Principles – developed at the request of the UN's Commission on Human Rights – are the result of a broad consultative process that has taken place since 2004 and has been endorsed by the UN Human Rights Council in 2012.[47]

They consist of a set of foundational principles, followed by a set of operational principles. Under the heading, "ensuring the primacy of human rights", they clarify that "*all States, whether acting individually or collectively (including through international and regional organizations of which they are members), have the obligations to respect, protect and fulfil human rights. They should ensure that any and all of their activities concerning their lending and borrowing decisions, those of international or national public or private institutions to which they belong or in which they have an interest, the negotiation and implementation of loan agreements or other debt instruments, the utilization of loan funds, debt repayments, the renegotiation and restructuring of external debt, and the provision of debt relief when appropriate, do not derogate from these obligations.*"[48] In consequence, the operational part of the Principles makes clear that governments' "*budgetary allocations should reflect the priority of human rights-related expenditure.*"[49] They go on to state that countries must design their debt strategies in a way that contributes to the necessary conditions to ensure that they fulfil their human rights obligations, and meets their social and economic needs and development requirements.[50]

The Guiding Principles also make clear that states' obligations do not just include the duty to ensure the progressive realisation of human rights, but also the satisfaction of minimal essential levels of rights, and any non-retrogression (i.e. any deliberate action that impairs rights). The UN Charter that all UN Member States have signed up to, and other human rights agreements, oblige international cooperation to contribute to these aims. This is remarkable as, given the evidence that international cooperation in the area of lending-with-conditionality is often laden with creditor-driven conditions that turn a blind eye to human rights impacts.

Finally, the Guiding Principles state that: "*Debtor States should not allow their external debt repayments to reach an excessive or disproportionate level at which they can no longer perform their minimum core obligations.*"[51] Thus, they do represent a trigger mechanism for when a state should stop paying down debt and call for a moratorium or outright debt restructuring.

Obviously, this trigger mechanism has not yet been applied in practice. Usually it is simply the inability to access new finance and rollover debts that first causes a default or almost-default, and eventually a slow and cumbersome debt restructuring process. Reasons for not triggering the mechanism include that, while the Guiding Principles have been adopted by the UN Human Rights Council, they have not been translated into related international and national law, neither do the human-rights clauses feature in debt contracts or bonds. This lack of codification causes the *pacta sunt servanda* dilemma that misleads budget allocation decisions by governments to the extent that they can become ruinous for the most vulnerable parts of the population. Loan contracts are pretty clear and explicit; financial implications of human rights obligations are often not so clear.

CSOs should therefore create awareness around the Guiding Principles and their fundamental message, the *Primacy of Human Rights over Debt Service*, with the aim to codify the principles in national and international law and, more narrowly, in simple commercial contracts related to debt such as loan contracts or bond clauses. A first step could be to make the human rights impact of debt management policies visible through systematic monitoring and analysis. This is both to raise general awareness, but also to create the necessary datasets that can give confused decision-makers better guidance for appropriate budget allocations.

Monitoring human rights impact

Compliance of all states with the Guiding Principles and the Primacy of Human Rights over Debt Service would ensure that the negative, or in some cases disastrous impact of debt and debt crises, is better controlled. However, there obviously remains a lot of room for improvement in this very practical arena. First of all, little is known about compliance. What is needed are systematic human rights impact assessments of debt management policies, as well as of financial assistance programmes by foreign creditors.

There is no such systematic assessment yet, but examples that point in the direction of what is needed do already exist:

- The World Bank conducts Poverty and Social Impact Analyses of its 'policy-dialogues' with Member States; this tool was introduced in response to criticism of the socially harmful nature of some reforms.[52]
- The European Commission (EC) has designed general guidelines on how to conduct human rights impact assessments.[53] Since 2014, the EC has been asked by President Juncker to consult social impact assessments of programmes funded by the European Stability Mechanism. A first report on Greece was released in autumn 2015.[54]
- The UN's Independent Expert on debt and human rights visits countries in debt distress; the country reports following from these visits include a rough assessment of the human rights impact.

It is, however, important to state that human rights impact assessments should be done by independent actors, and in any case not by an institution that is a creditor or that sides with creditors. The following example illustrates why: Both the EC and the UN Independent Expert recently carried out an assessment on Greece: The EC paper reads as if the authors' main intention is to whitewash the third ESM programme for Greece. It concludes that "*the measures envisaged under the new ESM stability support programme will bring Greece back to stability and growth, in a financially and socially sustainable way. In so doing, the burden of adjustment is distributed as equitably and as fairly as possible across society, and adequately takes account of the most pressing social needs and challenges in Greece.*"[55] The UN Independent Expert's report comes to a very different conclusion: He finds "*that the obligations of the Greek Government and international lenders towards rights-holders within the country continue to be side-lined, both in the design and implementation of the structural reform programmes.*" He concludes that "*Social and economic rights have been denied in a widespread manner.*"[56] The EC is part of the Troika that designed the creditor conditions imposed on Greece.

This example illustrates the fact that independent assessments of debt management policies and financial assistance programmes should become mandatory. The findings of such assessments could inform not just borrowing policies and debt management. They can also be the trigger for initiating debt restructuring processes. Last but not least, they can inform the design of adjustment programmes 'with a human face' when debt crises cannot be avoided.

Chapter 7: Preventing debt crises: Promoting responsible lending and borrowing

If all borrowers and lenders acted responsibly, most debt crises could be avoided. Loans that are provided with fair conditions from the lender side and used prudently by the borrower side should not lead to unsustainable debt, as well-spent money usually also creates assets in the same way as the liabilities that the loans create. An exception to that rule are debt crises related to hard-to-predict shocks, such as natural disasters, armed conflicts, major financial crises and their contagion effects, or commodity price crashes. Unfortunately, however, the policy and legal frameworks that regulate public finance are not yet up to the task to ensure responsible lending and borrowing.

1. Promoting universal consensus and acceptance for principles

It is uncontested that lending and borrowing should be responsible. The main problem is that "responsible" means different things to different people. This is also reflected in the inflation of soft-law standards and sets of principles that aim to promote self-regulation of borrowing and lending acts.[57] The large variety of principles related to responsible finance, and responsible lending and borrowing, indicates that there is no global consensus. The lack of consensus on a globally agreed set of standards also makes it difficult to hold actors to account.

The UN dealt intensively with the problem of how to prevent debt crises through responsible finance. The Monterrey Summit on Financing for Development of 2002 established that "*Debtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations.*"[58] The most relevant work to translate the 'co-responsibility' approach that was agreed in Monterrey into practice – and build consensus at the universal UN-level – has been done by UNCTAD. An inclusive expert group process resulted in the Principles on Promoting Responsible Sovereign Lending and Borrowing, presented at the UNCTAD XIII conference in 2012.

These 15 Principles represent a step forward in several senses: they acknowledge that quantitative debt limits are secondary to preventing debt crises. They rather put the focus of regulation on how loans are contracted, and how loans are spent. They do so in a balanced manner, defining principles for both lenders and borrowers. The agency principle for example clarifies that governments have the responsibility of protecting the interests of their citizens. Lenders must refrain from stopping government officials from performing their duties (for example, through bribes), and check that borrowers have been properly authorised. If not, they have to desist from concluding loan agreements.

The transparency principle includes that governments have to ensure proper approval and borrowing, and that parliaments should (ideally) be involved in this. Project financing requires solid ex-ante investigation and post-disbursement monitoring, including of both the social and environmental implications. Both sides have a duty to negotiate in good faith when debt needs to be restructured, and lenders must refrain from abusive measures, i.e. vulture funds litigation.[59]

The UNCTAD Principles received indirect endorsement by the international community through three UN General Assembly Resolutions. However, only 13 Member States have directly and explicitly endorsed them.[60] The limited number is probably also related to the fact that, due to resource constraints, UNCTAD staff were unable to conduct proper outreach. The UN's recent Addis Ababa Action Agenda reflects the problem. Paragraph 97 reads "*we take note of the UNCTAD principles on responsible sovereign lending and borrowing.*" However, after listing other principles, it continues by saying that we "*will work towards a global consensus on guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, building on existing initiatives.*"[61]

The UNCTAD Principles deviate to some extent from CSO proposals such as the Afrodad Borrowing Charter and the Eurodad Responsible Finance Charter. They were also criticised when they were released. For example, Latindadd was critical that they did not include obligatory debt audits with citizen participation, the right to cancel illegitimate debt, or a reference to the need for a universal debt workout mechanism, instead of bilateral negotiations between debtor and creditor(s).[62]

There is, however, good reason for debt justice CSOs – while working on stronger responsible finance standards – to promote acceptance of and compliance with the UNCTAD Principles. By outlining strong principles for both sides – creditors and borrowers, they clearly reflect the idea of the co-responsibility of debtors and creditors to prevent and resolve debt crises. This idea is nowadays being contested again.[63] Despite some shortcomings, CSOs are well-advised to promote awareness and acceptance of the UNCTAD Principles among borrowers and lenders, e.g. through general awareness raising activities and direct interactions with governments, parliaments and their respective institutions and branches that are in charge of lending and borrowing.

2. Promoting compliance: Monitoring and accountability mechanisms

There is no reason to think that lenders and borrowers automatically comply with voluntary principles, even for countries whose governments have formally endorsed these principles. As an incremental step towards full compliance, monitoring and accountability mechanisms need to be set up. Monitoring and accountability checks can and should happen at several levels.

Pillar 1: An international monitoring mechanism

So far, the UNCTAD and other parts of the UN system have not managed to set up a monitoring system for their Principles.[64] The UN's new general monitoring systems for financing for development – the future InterAgency Task Force Report – makes a first attempt to monitor responsible lending and borrowing, but just for a selection of the Principles.[65]

Beyond this, there is little systematic evidence regarding the extent to which individual countries comply. This would be key information for the accountability work of debt justice activists in these individual countries. Neither is there any cross-country analysis that would showcase best practice and publicly highlight which country is performing well or not so well. Such analysis would allow the development of best practice and would exert peer pressure on poor performers. Regular and repeated monitoring across time would also be needed to identify trends. The UNCTAD should urgently introduce an official monitoring mechanism for responsible lending and borrowing.

Pillar 2: Country monitoring

A second pillar is for countries to monitor their own compliance in the area of responsible lending and borrowing. A key example is the Norwegian debt audit of 2013. The government of Norway contracted a private consultancy firm to audit 34 debt agreements with seven developing countries against the UNCTAD Principles, which was their first systematic practical application.[66]

The advantage of national debt audits is that they should have more ownership than monitoring done by international organisations. The Norway case is, however, not a perfect practice example, as no follow-up action was taken. Other shortcomings of this pioneer case include that just a small sample of lending activities were monitored. A complete monitoring should have covered all lending (including by the Sovereign Wealth Fund), and the borrowing activities too.

Other countries have monitored from a borrower perspective only. One key example is the Ecuadorian debt audit of 2007.[67] Such audits, however, have not been monitored against a pre-established and consensual set of criteria or principles, which is why they could be considered as arbitrary by some parties concerned.

Generally, country-led or government-led monitoring is not fully independent, even if outsourced to third parties OR even if third parties are commissioned, and is therefore prone to political manipulation. Despite these shortcomings, however, it is worth promoting country-led and country-owned monitoring exercises.

To prevent audits along qualitative criteria from becoming a one-off exercise, as happened even in frontrunner countries such as Ecuador and Norway, it would make a lot of sense to instruct the national Supreme Audit Institutions – which monitor public finance anyway – to include Responsible Lending and Borrowing principles in their audit criteria, and to train national auditors respectively. The International Organization of Supreme Audit Institutions (INTOSAI) has already started to include the UNCTAD Principles as training modules.

Pillar 3: Citizen monitoring

The third pillar is citizen monitoring of public lending and borrowing, an activity that has become known as citizen debt audits. Numerous examples of citizen debt audits exist. Their reports include valuable case studies that illustrate irresponsible lending and borrowing and the illegitimate debt it creates.[68] Many of them are embedded in wider campaigns and fulfil wider functions, such as budget monitoring, and debt-related education and awareness raising in general. Citizen debt audit campaigns are an accountability instrument. As such they are similar to international or governmental monitoring mechanisms. While the latter ones have to be created by CSO advocacy, citizen debt audits are an activity that debt justice CSOs can and should do themselves.

The key advantage of citizen debt audits is that citizens can initiate these themselves, and at any time. However, they also have the positive side-effect that the audit process educates, empowers and mobilises citizens, which can create additional political momentum for actual reforms towards more responsible lending and borrowing. The disadvantage is that access to relevant information might not be easy in all countries. And that government ownership for the audit's findings might be low and consequently there may be no follow-up action taken by those in charge for borrowing and lending – unless sufficient political pressure can be built up.

It is problematic that most citizen debt audits currently operate in an ad hoc manner. They pop up and die so quickly that no one knows which ones are alive at any given point in time. Citizen debt audits should therefore be better institutionalised. First, in order to conduct repetitive audits across time. Second, to ensure follow-up to their audits, i.e. the communication, dissemination and advocacy work that is necessary to ensure impact. Moreover, citizen audits operate in a fragmented manner and coordinated action across borders does not take place. The audits are not comparable because they do not audit against the same set of pre-established criteria. Citizen debt audits should monitor against pre-established and predictable criteria, such as the UNCTAD Responsible Lending and Borrowing Principles.

3. Sanctioning non-compliance: Illegitimate debt must be cancelled

Principles usually contain some elements that are embedded in national or international law. To these they add additional principles that are derived from good practice or normative elements – as the different actors behind the principles interpret them. These are less well protected by legal means and the sanctioning mechanisms that law enforcement has at their disposal. As a whole, none of the existing sets of principles can be considered hard law: thus they are not legally binding and enforceable. They are soft law tools that suffer from the usual problems: namely that compliance is not enforceable, and is usually low. As long as the full codification in national law and international law is not given, other sanctioning mechanisms must be applied.

Sanctions should happen when violations are discovered. However, even for hard-law components (such as those related to corruption), sanctioning abuses is also difficult because many lenders are based outside the borrower country's jurisdiction, and thus outside the reach of its law enforcement system. The lender countries' own law enforcement systems might remain passive because lenders are usually politically influential actors in their countries. They might be governmental agencies (take export credit agencies, or bilateral development banks) or even multilateral institutions benefiting from immunity clauses. An effective ex-post sanctioning mechanism is therefore necessary to ensure that debt found non-compliant with responsible lending and borrowing principles is not being repaid. In other words, illegitimate debt must be repudiated by the debtor, and eventually cancelled. This is in the interest of responsible lenders as only the elimination of illegitimate debt can avoid debt crises and debt restructurings, and thus ensure that their loans are being repaid.

Chapter 8: Resolving debt crises: An international debt workout mechanism

Resolving unsustainable debts in a fair, speedy and sustainable manner requires an adequate international debt workout mechanism. This fact is not new. Awareness has existed for a long time and proposals regarding what such a debt workout mechanism might look like are numerous. But political blockades, mainly by the creditor side, implied that this "gaping hole" in the international financial architecture – as the former IMF Deputy Director Anne Krueger called it[69] – have not been filled yet. The fact that capitalist economies and their boom-bust cycles would need effective institutions to tackle debt crises – in particular those related to external[70] and sovereign debt – is as old as capitalism itself, and has kept intellectuals and policy-makers busy ever since. Below is an explanation about how it has evolved over the past few decades:

Keynes' 'use-it-or-lose-it' debt workout mechanism

Faced with the challenge of how to resolve the massive debt problems and macroeconomic imbalances created by the Second World War, the British economist John Maynard Keynes suggested a 'use-it-or-lose-it' debt workout mechanism as part of an International Clearing Union. The proposal aimed to avoid repeating the mistakes made after the First World War, when unresolved debt problems triggered the Great Depression. It had obliged surplus nations (i.e. net creditor nations) to either import from debtor nations, build factories in debtor nations or donate to debtor nations, thus giving debtors a chance to get rid of (external) debt.

The proposal was rejected by the US delegation as the world's largest net creditor at the time when the Bretton Woods System (BWS) had been set up from 1944. Instead, the BWS turned a blind eye to the fact that states could be bankrupt and rather set up two bailout institutions whose role became to provide new loans – new liquidity – to indebted states: the World Bank and the IMF. Thus, the system was built for procrastinating over sustainable debt crises solutions. This was the original sin.

The London Debt Agreement approach

The 'use-it-or-lose-it' debt workout procedure did inspire the London Debt Agreement of 1953, the outcome of the Conference on German External Debts that resolved West Germany's post-war debt problems. Key features of the Agreement included that creditors agreed to write off a substantial share. They agreed to an actual haircut of about 50% on outstanding loans ('lose it'). Moreover, it contained the clause that debt service would be financed exclusively by trade surpluses, thus creating an incentive for creditor nations to import goods from the debtor if they want to be repaid ('use it'). This repayment plan protected Germany's economic substance, which would have been destroyed by an austerity-type repayment plan financed by fiscal savings. The ban on financing the repayment of old debts through capital imports (i.e. new debts) led to the actual debt reductions instead of a simple rollover of debts. Other features of the London Debt Agreement include that all external debts, public and private, were treated in one comprehensive process, and that the parties negotiated on an equal footing. The London Debt Agreement is widely considered as one of the world's largest, most successful and most sustainable debt workouts.[71]

Politically it was made possible by a shift in US attitudes. The geopolitical aim of enabling West Germany to play its role as ally and frontline state in the Cold War became prevalent, and the US used its power to convene all relevant creditors around the table. Although the approach was so successful, certainly a good practice if not a best practice case of debt crisis resolution, debt workouts along the London Debt Agreement approach have not been institutionalised or repeated. Geopolitically motivated debt workouts have been repeated, however. For example, examples took place in Indonesia in 1969, Iraq in 2005, and numerous times at the Paris Club. In the Iraq case, then US Director of Treasury John Snow even cited allegations of odiousness or illegitimacy as reasons for debt relief.[72]

Responses to the developing country debt crises since the 1970s

Both policy development and intellectual debate stagnated in the quiet times between the 1950s and 1970s, when debt crises were a rare phenomenon. They picked up in the 1970s when it became evident that the lending and borrowing boom had caused unsustainable debt problems in most of the global south.[73] In the run-up to the 1979 UNCTAD Conference in Manila, the G77 suggested setting up an International Debt Commission made up of eminent people who would offer a more neutral forum for debt renegotiations than the Paris Club or the IMF. In 1981, Christopher Oechsli suggested a procedural framework for debt renegotiation that solves coordination problems across different debt and takes the basic needs of indebted countries into account. This framework could be a court-like body, or arbitration clauses in loan contracts.

IMF-based solutions were always contested, due to the fact that the IMF – as creditor and political actor controlled by creditor nations – is not a neutral actor and should therefore not be the decision-maker in debt crisis resolution. Academics such as Barnett, Galvis and Gouraige envisaged a "supranational, multilateral body" established by a multilateral convention that would be independent from the IMF, convene debtor and creditor negotiations and establish fair terms for debt restructurings.

Jeffrey Sachs in turn suggested solving the conflict-of-interest problem of the IMF by reforming the IMF from a bailout fund into an insolvency court: "*IMF practices should be reorganized such that the IMF plays a role far more like an international bankruptcy court and far less like the lender of last resort to member governments.*"[74] Long before the Greek disaster, he had realised that the bailout strategy is doomed to fail, that bankrupt countries need a clean slate and fresh start instead. More recently, the idea of setting up an international insolvency court has also been picked up and promoted further by academics working with Latindadd (Alberto Acosta and Oscar Ugarteche) and Afrodad (John Lungu).[75]

The question remains regarding the basis on which an international court or any other arbitration body should make their judgments, as there is no international insolvency law. In 1987, the Austrian economist Kunibert Raffer developed a debt workout approach that builds on Chapter 9 of the US insolvency law, the chapter for insolvency of municipalities. It also includes a plan to set up a neutral court of arbitration and establishes the right to be heard for affected populations. This proposal also inspired CSO proposals for a "Fair and Transparent Arbitration Procedure" (FTAP) over the following decades.[76]

In 1990, Daniel Kaeser suggested a sovereign debt workout mechanism at the IMF. The main innovation was that his proposal aimed to resolve debt problems of countries that were overindebted as defined by objective criteria, not just for countries that had payment difficulties or defaulted. With this proposal came the move from a 'can no longer pay' to a 'should no longer pay'-thinking in debt workouts that should soon inspire the debt relief initiatives for the Heavily Indebted Poor Countries (HIPC).

The practical evolution

The HIPC was a debt workout mechanism designed for and targeted to low-income countries. The first one was set up in 1996, an enhanced version in 1999, and it was finally complemented by the Multilateral Debt Relief Initiative (MDRI) in 2005. HIPC/MDRI was an exceptional innovation because a whole group of countries benefitted from debt relief. The 36 countries that benefitted from HIPC/MDRI have so far received US$125.7 billion in debt relief between them.[77]

Politically, these initiatives were largely a result of civil society pressure: the big Jubilee mobilisation campaign of the late 1990s and early 2000s that targeted primarily G7 summits at which the initiatives were agreed.[78] HIPC/MDRI debt relief, however, was everything else but a speedy debt workout. Twenty years after the first HIPC initiative was agreed, some eligible countries still have not reached their 'Completion Point'. The debt workout process was cumbersome, creditor-led and laden with conditionality. And it was far from a comprehensive process: HIPC was for official bilateral loans of Paris Club creditors, and since MDRI also for multilateral loans. The amount of additional resources that the debt relief provided was also limited, especially because debt relief could be counted as ODA and often reduced future ODA disbursements. In particular, the multilateral development banks could deduct the costs of debt relief from country allocations under the MDRI. Last but not least, it was simply expected that other creditors would comply with the 'comparability of treatment' visions of Paris Club creditors, thus providing an open invitation for those creditors to sell their claims to vulture funds, and for vulture funds to sue HIPC countries.

Nevertheless, HIPC/MDRI was indeed effective and cleared the debt overhang of eligible countries for quite some time, especially in sub-Saharan Africa where most of the HIPC countries were located. The external debt to GNI ratio of the whole region has fallen remarkably since the 1990s, and has stayed at low – if not insignificant – rates until recently. The initiatives together worked like budget support. They provided real new fiscal space, whereas previous debt relief initiatives often just rescheduled payments, or cancelled debts whose repayments were highly unlikely. The neoliberal conditions attached to it, however, made eligible countries more vulnerable to a new wave of debt crises, as even IMF staff now acknowledge.[79]

The main problems with HIPC/MDRI were that it was designed as an ad hoc initiative that has in the meantime expired. No new country can qualify – and eligibility was restricted to low-income countries. This obviously failed to acknowledge that middle- and high-income countries can go economically bankrupt, and eventually suffer from severe and prolonged debt crises too.

The IMF proposal for a Sovereign Debt Restructuring Mechanism

The phase of conceptual and practical work related to developing countries culminated in the IMF's own proposal for a Sovereign Debt Restructuring Mechanism (SDRM). The IMF activism in this area was triggered by the Asian financial crisis that started in 1997 and, through contagion effects, soon reached other major middle-income countries such as Russia, Brazil and ultimately Argentina in 2001.

In a similar way to other proposals, the IMF's own SDRM suggested setting up a new institution for negotiation, arbitration and decision-making, the Sovereign Debt Dispute Resolution Forum (SDDRF). The Forum would draw members from a pool of arbiters. The selection would be made by the IMF's managing director. The strength of the SDRM proposal was that it would build on an amendment of the IMF Articles of Agreement, which are international law, thus it could make legally binding decisions. The weakness was that it would put the IMF in a strong position, with all the conflict of interests that this involved. Needless to say, this IMF proposal suggested that IMF loans should be excluded from debt restructuring. The IMF-dominance was also the key reason why CSOs refused to back the SDRM idea.

In any case, it failed to find the necessary majority in the IMF board, and finally had to be shelved due to strong resistance by the US and some emerging economies.[80] Still, the SDRM attempt in 2001/2002 was the first and most relevant regime-building initiative towards an effective debt workout mechanism from the IMF's side. And also the last relevant IMF initiative since the blockade in the IMF board has never been lifted since.

After the global financial crises

A third wave of reform, or reform proposals, was triggered when the global financial crisis started in 2008 and soon led to a new wave of sovereign debt crises (partly through bank bailouts). This time the crises even hit high-income countries, especially those in the Eurozone. In particular the failure to solve the Greek debt crisis under the current non-regime inspired new thinking. But there was also a parallel event, the aggressive vulture funds litigation against Argentina at New York courts.[81] As the IMF channel remains blocked, regime-building efforts now take place at the United Nations.

Soon after the crisis started, the UN Commission of Experts for Reforms of the International Monetary and Financial System, the so-called Stiglitz Commission, revived the idea of establishing an International Debt Restructuring Court (IDRC) whose decisions would be recognised by national courts and therefore would be binding and enforceable decisions on debt resolution. The IDRC would also be mandated to assess if debt was odious.[82] A softer academic proposal is Gitlin and House's idea to set up a Sovereign Debt Forum, a neutral body to facilitate consultation and information sharing between a debtor and its creditors.

The UNCTAD Roadmap and Guide for Sovereign Debt Workouts

The UNCTAD Roadmap and Guide for Sovereign Debt Workouts is the culmination of the proposals since the beginning of the global financial crisis.[83] From 2013 on, UNCTAD had convened a multi-stakeholder expert group, and finally released the Roadmap and Guide in 2015. The Guide establishes five debt workout principles: Legitimacy, impartiality, transparency, good faith and sustainability).

Similarly to other proposals, the UNCTAD approach contains a proposal for a concrete institutional innovation, the Debt Workout Institution (DWI). It also picks up the idea of conducting sovereign debt restructurings in a pre-emptive manner, not just when an actual default has happened. In addition, it calls on the international community to develop early warning indicators that could trigger a debt restructuring process.

It suggests a 17-step debt workout process that puts debtor countries in the driver's seat. Some of the key features include that a debt sustainability analysis is carried out by the debtor state. If debt is found to be unsustainable, the debtor state invokes an immediate standstill on payments and contacts the DWI. The DWI then helps with outreach to creditors and convenes an initial roundtable that would validate the debt sustainability assessment, and initiate debt restructuring negotiations. These could take different forms, either through direct negotiations, or led by a mediator, or by an independent arbitration panel. The process would include a validation of claims, which could also serve to identify claims that are illegitimate. The debtor state would also define an economic and social recovery programme with the full involvement of domestic stakeholders. The process would end with a binding debt restructuring agreement, after which the debtor resumes payment on restructured debt instruments.

Tackling vulture funds

Vulture funds increasingly intervene in debt crisis management. Even if their litigation strategy fails, it makes debt crisis resolution more time-consuming and, due to the delays, more costly. If they succeed, it makes resolutions much more costly. Argentina had to transfer more than US$10 billion to vulture funds following rulings by a New York court. It also leads to unfair outcomes: Responsible investors – investors that acknowledge the need to write off a share of outstanding loans when the debtor cannot pay – face over-proportionally high losses. Vulture funds that litigate – and invest additional money to corrupt legal and political systems near strategic financial centres – make profits that can amount to more than 1,000%.

The vulture fund business model is made possible by the absence of a bankruptcy regime for sovereign debtors – a bankruptcy regime designed in a way that would make their business model impossible. Of course, a multilateral legal framework for sovereign debt restructurings with global reach would be the most effective way to combat the plague of vulture funds. National vulture fund legislation is, however, a step in the right direction. Because it can be introduced unilaterally, it is therefore politically easier to achieve, and national laws can inform the creation of a multilateral legal framework.

Where CSOs decided to invest in thorough vulture fund campaigns, they were successful: Major civil society campaigns directed towards vulture funds legislation took place in Belgium and the UK.

The Jubilee Debt Campaign's "Stop Vulture funds" campaign in the UK exposed cases of vulture fund legislation and the illegitimate profits the vultures made through their own analysis and media work. This was initially mainly for low-income countries. The cases of Liberia and Zambia were widely used, but increasingly also for middle-income countries such as Argentina or former high-income countries such as Greece. This was complemented by petitions, direct interactions with policy-makers but also by public stunts at key moments in key locations.

More than 40% of all sovereign bonds worldwide that are issued under foreign law are issued under English law. Consequently, London is also a key venue for vulture fund litigation, so there was a wealth of opportunities and locations for campaigning in the UK.

The first phase of the UK campaign led to the Debt Relief (Developing Countries) Act of 2010.[84] The essence of that law is that vulture funds could no longer recover higher payments through litigation than they would have received when the debt they held had participated in the debt relief for the Heavily Indebted Poor Countries (HIPC). The main caveat is that its geographic scope is HIPC only. Another problem is that it only covers debts that were the result of loans given before 2004.[85] The law was effective in the sense that litigation against HIPCs actually stopped at London Courts. The campaign continues to strive towards the politically more ambitious target of introducing a vulture fund law that has universal reach.

The Belgian campaign was led by the Belgium headquartered CADTM, in cooperation with Belgian civil society actors such as 11.11.11 and CNCD. The campaign managed to attract political support. The laws that followed were passed by large cross-party majorities in the Belgian Parliament. While Belgium does not host a financial centre of similar relevance to the City of London, vulture funds legislation there is crucial because the Euroclear payment system is based in Belgium. (In order to enforce their claims, vulture funds often try to confiscate payments that debtors make to other creditors. In the EU, such payments go through the Brussels-based Euroclear system.) Vulture funds legislation can ensure that they no longer intercept and confiscate these payments.

A law passed in 2008 also immunised funds Belgian development assistance funds from vulture funds attacks. Two more vulture fund laws were adopted by the Belgian Parliament in 2015. They have the widest scope so far because they are applicable to all state debt, whatever the issuer country. They stop creditors from seeking an illegitimate advantage that can enforce their claims in Belgium because they immunise the assets of foreign states in Belgium. Vulture funds are here described as creditors that have purchased debt at far below face value, refuse to participate in a debt restructuring and litigate to achieve full payment.[86] The passing of the laws has led to protests by vulture funds, which have launched a lawsuit to claim it unconstitutional.

The Belgian law has already inspired other countries to take similar initiatives. In 2016, France was the next country to discuss vulture fund legislation in Parliament.[87]

The UN process towards a legal framework for sovereign debt restructuring

The final stage of expert deliberations that led to the UNCTAD Roadmap overlapped with a new political regime-building process. In 2014, the UN General Assembly had passed a Resolution that mandated an ad hoc committee at General Assembly level to negotiate a multilateral legal framework for sovereign debt restructurings, within the ambitious timeframe of just one year.[88] The Resolution was triggered by the aggressive vulture fund litigation against Argentina that had already started in the early 2000s. A New York judge court ruling had forced Argentina to pay the vulture funds in full. When the US Supreme Court refused to take Argentina's appeal, the G77 sought a way to protect sovereign debtors that need to restructure their debts through a multilateral mechanism agreed at UN level.[89]

The initiative was a breakthrough. CSOs in particular welcomed the fact that the UN General Assembly, as the world's most inclusive body for regime-building, had finally taken leadership. The General Assembly process could build on numerous political mandates to create a new debt workout mechanism, in particular the agreements made at the International Conferences on Financing for Development in Monterrey (2002) and Doha (2008). It could also build on the technical work done within the UNCTAD and UN Department of Economic and Social Affairs (DESA) over decades. The UNCTAD Roadmap and Guide informed the Committee's work.

However, the process faced a lot of political resistance. Even the Resolution that mandated the process could not be adopted by consensus. Only the G77 votes secured a majority, while the majority of EU Member States abstained and 11 countries voted against, including major financial centres and creditor nations such as the US, UK, Germany and Japan. Also, financial centres and creditor nations within the G77 (such as Singapore and China) seemed not fully convinced about creating a new framework at UN level that might regulate their room to manoeuvre. The drivers of the process, mainly Latin American countries close to Argentina, therefore lowered the ambitions and proposed to agree to develop a set of principles within the one-year timeframe, leaving future steps to a follow-up process.

This set of nine principles that was finally adopted by a UN General Assembly Resolution in September 2015 includes the five general principles defined earlier by the UNCTAD expert group. However, because this UN process was so heavily influenced by the negative experiences made with vulture funds litigation at foreign courts, it includes four additional principles specifically targeted to protect sovereign debtors in crisis from litigation. These are the sovereign right to restructure, the equitable treatment of different creditors, the sovereign immunity from jurisdiction and execution, and that majority restructurings must be respected by holdouts. The Resolution also contains a mandate for a follow-up process.[90]

The fact that the UN process so far only led to a set of Principles, instead of a new debt workout mechanism including tangible procedural, legal and institutional innovations, is of course a disappointment. A second missed opportunity, especially from a CSO perspective, is that the Principles failed to embed sovereign debt restructurings in a development and human rights context. This could be the main asset of a regime-building process at UN level, as compared to an IMF-led process. The sheer existence of a UN mandate in the area of debt workout mechanism is, however, an innovation in its own right, and something the international community can build on.

Towards a new debt workout mechanism – where do we go from here?

Among experts, it is uncontested that better institutions for debt crises resolution are needed. As shown above, proposals for new international institutions and process-innovations are manifold. Specialised insolvency courts and the rule-of-law approach established by clear and predictable insolvency laws have turned out to be useful when it comes to resolving corporate and private insolvencies, so why should it be different in the case of state insolvencies?

Institution-building has so far failed due to political blockades. The creation of new debt workout mechanisms is a clear prisoners' dilemma situation: while the international community of nations would no doubt be better off if debt crises could be fully prevented, or at least resolved in a speedy, fair and sustainable manner by effective institutions, a small minority of individual countries tend to judge (irrationally) that such an innovation might be against their interest.

Ironically, the coalitions of both proponents and opponents are fragile and change over time (and actors do not necessarily base their positioning on rational criteria). The heavily indebted Germany for example, was the main beneficiary of a comprehensive ad hoc debt workout process in the 1950s. Even when it had turned into a net creditor, it remained a main driver of innovations and a firm supporter of the IMF's work on the SDRM in the early 2000s, but eventually joined the group of blockers when the UN process started in 2014. Argentina and Brazil were against the SDRM proposal in the early 2000s, when they were in debt distress themselves (and feared their support could trigger a creditor panic). When Argentina faced vulture litigation and stood with its back against the wall, it turned into a supporter of the UN process. This proves that country positions change and can be changed.

Explicit support for a global debt management reform focusing on a new state insolvency mechanism has at some point also been expressed by Switzerland, Norway and the Netherlands. Switzerland's endorsement in particular is remarkable because it counters the perception that nations hosting important financial centres were against international mechanism. Resolutions in favour also came from the European Parliament and the Andean Parliament. That these overarching parliaments spoke out in favour, while some of their Member States' governments had positioned themselves against, confirms the prisoners' dilemma: Reforms are in the collective interest. Parliaments representing a broad transnational constituency know that and position themselves accordingly.[91]

Another key factor that determines country positioning is domestic political considerations. The US supported reforms twice: first in the early stages of negotiations on the Bretton Woods System; later in early stages of the negotiations on the SDRM. In both cases Wall Street lobbyists turned the government around. On the opposite side, countries that positioned themselves in favour did so because they had special national interests. They did so because strong civil society campaigns in these countries pushed for it.

Conclusion

Developing countries have witnessed substantial changes in their debt problems/composition over the years. The share of their debt stock that is official external loans from Western creditors and IFIs has decreased. This is partly a consequence of the fact that official loans have been paid off or relieved through multilateral debt relief initiatives.

At the same time, new borrowing has gone private. More and more governments in developing countries have started to borrow from private sources, foreign and domestic, including by issuing bonds on global financial markets. They have also entered into debts that are off-balance sheet, for example, through public-private partnerships.

Private actors in developing countries have also borrowed more. Governments are not directly liable to guarantee the repayment of loans taken out by the private sector, but an overleveraged private sector creates substantial financial risks for the state, as private insolvencies could destabilise the financial system and force the government to finance bailouts with public monies. The financial crisis in Southeast Asia in the late 1990s and the Eurocrisis are examples of how costly this can become.

The result is that current institutions to manage debt crises are no longer able to do their job and are no longer able to prevent or manage debt crises. The Paris Club once managed the restructuring of Western bilateral loans when this became necessary, but this type of debt has lost relevance. The London Club once used to restructure loans given by private banks, but developing countries now increasingly issue bonds, instead of borrowing bank loans. The HIPC and MDRI debt relief initiatives once tackled official loans from bilateral and multilateral sources, at least for low-income countries, but these have now expired.

This highly dynamic debt landscape is regulated by an institutional framework for debt crisis resolution and management that could be called patchy and antiquated, at best. Debt crisis prevention never worked well, as proven by the more than 600 cases of sovereign debt restructuring that were needed between 1950 and today – three times more cases than countries on this planet. The non-regime for debt crisis resolution turned out to be unable to conduct fair, speedy and sustainable solutions to debt crises, leading to lost decades for development in affected countries.

The evolving nature of debt poses even greater challenges. The fact that the SDG implementation begins in a difficult economic environment makes it even more important that the debt regime is modernised and regulation gaps are being filled.

We have identified three different dimensions, and related policy processes that are in an infant stage:

1. There is the need to clarify the role that debtor states' obligations towards creditors play in relation to other state obligations, in particular in the area of development and human rights. Governments lack clear guidance when it comes to allocating scarce public resources and making debt management decisions, including debt restructuring decisions. The UN Human Rights Council's Guiding Principles on Debt and Human Rights give guidance.
2. There is a need to ensure truly responsible lending and borrowing. Here, there is no lack of soft law instruments covering individual debt types or institutions (there are so many that governments may feel confused rather than informed), but there is a lack of a uniform approach covering the whole sovereign debt stock. The UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing offer a uniform approach.
3. There is still no bankruptcy regime (or debt workout mechanism) for sovereign debtors. It is a well-known 'hole' in the international financial architecture that remains to be filled. There is no lack of proposals regarding how to fill this hole. The IMF had a proposal for a Sovereign Debt Restructuring Mechanism; the UN has proposed initiatives towards a multilateral legal framework for sovereign debt restructurings; and proposals have been put forward by CSOs and academia to introduce international debt courts or fair and transparent arbitration procedures.

The key challenge is to overcome political deadlocks and design regime-building processes. Citizen pressure will have a key role to play in order to ensure that the debt regime at some point in the future is designed to better serve people and development.

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43. Even bondholders started using this channel. One prominent example is the case of Argentina versus a group of 60,000 Italian bondholders, which has been treated by the International Centre for the Settlement of Investment Disputes (ICSID), a part of the World Bank Group, on the basis of the Argentinean-Italian bilateral investment treaty, cf. Caroline Simson (2016). Argentina settles historic ICSID row with Italian bondholders.
44. United Nations (2011). Guiding principles on foreign debt and human rights, A/HRC/20/23, para 3.
45. Cf. Jesse Griffiths and Konstantinos Todoulos (2014). Conditionally yours. An analysis of policy conditionally attached to IMF loans.
46. Spain is a prominent example, the Constitution's new paragraph 135 states that debt service "shall have absolute priority"; cf. José M. Abad and Javier Hernández Galante (2011). Spanish Constitutional Reform. What is seen and not seen, CEPS Policy Brief, p. 2.
47. UN General Assembly Resolution A/HRC/RES/20/10, adopted by recorded vote.
48. United Nations (2011). Guiding principles on foreign debt and human rights, A/HRC/20/23, Annex, para 6.
49. Ibid, para 49.
50. Ibid, para 8.
51. Ibid, para 50.
52. World Bank Brief Poverty and Social Impact Analysis.
53. European Commission, Operational Guidance on taking account of Fundamental Rights in Commission Impact Assessments, from 6 May 2011, SEC(2011) 567 final.
54. European Commission, Assessment of the Social Impact of the new Stability Support Programme for Greece, from 19 August 2015, SWD (2015) 162 final.
55. Ibid, p. 20.

56. UN Human Rights Council: Report of the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights on his mission to Greece, A/HRC/31/60/Add.2, p. 19.
57. Mathieu Vervynckt (2016): Official multilateral responsible financing standards – State of Play; Eurodad (pending).
58. United Nations (2002). Monterrey Consensus on Financing for Development, para 47.
59. UNCTAD (2012). Principles on Promoting Responsible Sovereign Lending and Borrowing.
60. Argentina, Brazil, Cameroon, Gabon, Germany, Honduras, Italy, Morocco, Nepal, Norway, Mauritania and Paraguay
61. United Nations (2015). Addis Ababa Action Agenda (AAAA), para 97.
62. Latindadd letter to the UNCTAD expert group, 25 October 2012 (unpublished).
63. The text in the AAAA puts the major burden on the borrower: "We reiterate that debtors and creditors must work together to prevent and resolve unsustainable debt situations. Maintaining sustainable debt levels is the responsibility of the borrowing countries; however we acknowledge that lenders also have a responsibility to lend in a way that does not undermine a country's debt sustainability."
64. One should add that debt justice CSOs such as Eurodad or Afrodad do not monitor in any systematic way against the Principles CSOs have developed.
65. Cf. United Nations (2016). Inaugural 2016 Report of the Inter-agency Task Force on Financing for Development – Addis Ababa Action Agenda: Monitoring commitments and actions, p. 106-107.
66. Deloitte (2013). Report Norwegian Debt Audit, for a critical assessment see Gina Ekholt (2013). Norway conducts first creditor audit.
67. Comisión de la Auditória Integral de la Deuda Pública: www.auditoriadeuda.org.ec
68. The website of the International Citizens' Debt Audit Network gives an overview: http://www.citizen-audit.net/
69. Anne O. Krueger (2001). An International Financial Architecture for 2002. A new approach to sovereign debt restructuring.
70. Domestic debt problems are easier to solve because additional policy instruments exist: Domestic currency debt can be 'inflated away' by Central Bank intervention. To restructure debt instruments under domestic law, national parliaments can pass the necessary legislation, such as the Greek law of 2012 that retrofitted collective action clauses to Greek-law bonds and thus made their restructuring possible. And governments have numerous options to pressure domestic creditors to act in the national interest. Policy options are much more limited when it comes to external debt (external currency and/or external creditors and/or foreign law).
71. Cf. Jürgen Kaiser (2013). One Made it Out of the Debt Trap. Lessons from the London Debt Agreement of 1953 for Current Debt Crises.
72. The odious debt doctrine was, however, not invoked, due to fears that it would serve as example for other cases of less geopolitical relevance. Cf. Jai Damle (2007). The odious debt doctrine after Iraq.
73. Cf. For the evolution of debt workout mechanisms during the developing country debt crises: Kenneth Rogoff and Jeromin Zettelmeyer (2002). Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001.
74. Ibid., Rogoff/Zettelmeyer, p. 11.
75. Kaiser op cit, p. 18.
76. See for example: CIDSE and Caritas Internationalis (2004). Sustainability and Justice. A Comprehensive Debt Workout for Poor Countries with an International Fair and Transparent Arbitration Process (FTAP), p. 6-7.
77. For an excellent summary of HIPC/MDRI see: Cassimon, Danny, Dennis Essers and Karel Verbeke (2015). What to do after the clean slate? Post-relief public debt sustainability and management, p. 5-24.
78. Sasja Bökkerink and Ted van Hees (1998). Eurodad's campaign on multilateral debt. The 1996 HIPC debt initiative and beyond; and Somers, Jean (2014). Transnationalism. Power and Change: 30 years of debt campaigning.
79. Cf. Tiago Stichelmans (2016). IMF researchers warn: neoliberal policies increase inequalities and jeopardize growth.
80. Cf. Anne O. Krueger (2002). A new approach to Sovereign Debt Restructuring; and for a critical reception Jürgen Kaiser (2013). Resolving Sovereign Debt Crises. Towards a Fair and Transparent International Insolvency Framework, p. 20-22.
81. For an overview, see IMF (2013). Sovereign Debt Restructurings. Recent reform proposals and implications for the Fund's legal and policy framework.
82. United Nations (2009). Report of the Commission of Experts of the President of the United Nations General Assembly on the Reform of the International Monetary and Financial System.
83. UNCTAD (2015). Sovereign Debt Workouts: Going forward. Roadmap and Guide.
84. Cf. http://www.legislation.gov.uk/ukpga/2010/22. The law was initially valid for one year only, but became permanent in 2011.
85. IDA and IMF (2010). Heavily Indebted Poor Countries (HIPC); and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation, p. 22.
86. Cf. Jan van de Poel (2015). New anti-vulture funds legislation in Belgium. An example for Europe and the rest of the world; For an English summary see: Jacques Richelle (2016): Belgian 2015 Anti-Vulture Funds Law;
87. Plateforme Dette et Développement (2016): Loi Sapin 2: Un premier pas dans la lutte contre les fonds vautours
88. United Nations (2014), Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes, A/68/304.
89. Cf. Bodo Ellmers (2014). Sovereign Debt Restructuring. UN takes a big step forward.
90. UN General Assembly (2015). Basic Principles on Sovereign Debt Restructuring Processes, A/Res/69/319.
91. For a mapping of country positions, see Jürgen Kaiser (2013). Resolving Sovereign Debt Crisis. Towards a Fair and Transparent International Insolvency Framework, p. 28-30.

Eurodad

The European Network on Debt and Development (Eurodad) is a network of 47 civil society organisations (CSOs) from 20 European countries, which works for transformative yet specific changes to global and European policies, institutions, rules and structures to ensure a democratically controlled, environmentally sustainable financial and economic system that works to eradicate poverty and ensure human rights for all.

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