erlassjahr.de
Entwicklung braucht Entschuldung

Arguments against a Sovereign Debt Workout Mechanism (SDWM)

Arguments against a Sovereign Debt Workout Mechanism (SDWM)

18.09.2018

This is a translation of „ Fachinformation 55: Häufig erhobene Einwände gegen ein Internationales Insolvenzverfahren“, first published 08.04.2016.

erlassjahr.de - Entwicklung braucht Entschuldung
Carl-Mosterts-Platz 1
40477 Düsseldorf
Tel.: +49 (0) 211 - 46 93 - 196
Fax: +49 (0) 211 - 46 93 – 197
Email: buero@erlassjahr.de
Website: www.erlassjahr.de

Authors: Jürgen Kaiser und Michael Wittmann
Contact: j.kaiser@erlassjahr.de

Arguments against a Sovereign Debt Workout Mechanism (SDWM)

by Jürgen Kaiser and Michael Wittmann

"Insolvency procedures are for companies and not for states as these are sovereign."

Of course, states can also go through an insolvency procedure just like companies or private households. In all three cases we deal with autonomous institutions whose debt levels have become so unsustainable that they cannot service all of it anymore. And it is especially because of sovereignty of public debtors that a suggestion for a SDWM is based on Chapter 9 of US insolvency law. Chapter 9 deals with insolvency of (some) regional authorities in the US. It was designed exactly for the purpose of being able to conduct insolvency procedures under the special circumstances of debtors with sovereign powers. Its basic principles can – and should – be also applied internationally.

"There is no international bailiff – that's why an arbitration ruling couldn't even be enforced."

It's true that there is no institution and no procedure that could fill out the task of an international bailiff. Nevertheless, there is also no such institution in the existing procedures, in the Paris Club for example, which is the cartel of the traditionally most important creditor nations. However, the affected parties normally accept the concluded agreements because they believe to gain more from cooperation based on those agreements than from repeated confrontation. This is a characteristic of most international agreements that in most cases cannot be enforced by some sort of "world police" and that are respected nevertheless.

There is a political and economical advantage of negotiations on eye-level between creditor and debtor. Every experience points towards the fact that conflict resolutions are only accepted and therefore successful when they are the result of negotiations that are perceived as fair or at least deemed acceptable by both sides. This very conditions are not met in the Paris Club; the notion of forcing private creditors, especially banks, to participate in so-called „equal treatment clauses" even though they had not been part of setting up the rules and criteria of the Paris Club, has always worked only partially. With regard to private financial flows exceeding the public ones significantly and being promoted by international financial institutions as the future means of financing even in poor countries, this aspect is of special importance. These difficulties underline the necessity of comprehensive procedures that include all affected parties.

"An International Insolvency Procedure would require an elaborate international bureaucracy."

An international procedure modelled on the US insolvency law (Chapter 9) would require neither an international organisation nor an elaborate bureaucratic procedure. As long as the parties that agreed on the principles of the procedure are upholding them, there is no need for an international treaty even though that might be helpful in the long run.

The necessary efforts to conduct such a procedure would be manageable: creditors and debtors are already employing qualified staff that is able to negotiate sustainable agreements; not negotiations would not be based on the law of the jungle as in the Paris Club but rather on eye-level in front of an impartial decision maker. Since a court of arbitration of three to a maximum of five persons is required for such a procedure, a small secretary that assumes technical tasks would be enough. This could hardly be considered an "elaborate international bureaucracy".

Besides the ad hoc arbitration process, some experts also suggest a permanent institutionalized mechanism – for example the creation of a State Insolvency Chamber at the Permanent Court of Arbitration (PCA) in The Hague. A permanent institution that exists regardless of whether it is used or not would be more expensive than an ad hoc procedure. The integration into an already existing institu-

tion with routine proceedings and qualified personnel, however, would contain the institutional expenses in that case as well.

"Instead of inventing a whole new procedure, you should better work on already existing ones. The HIPC-Initiative has already taken up lots of elements of an SDWM anyway."

This is a dangerous misinterpretation as almost all elements of a fair and transparent debt workout mechanism are missing in the Heavily Indebted Poor Countries (HIPC) Initiative. It was decided by the G8-creditors, and the creditor institutions IMF and World Bank developed and controlled the procedures. As a result, from its beginning in 1996 until the complete cancellation of almost all multilateral debt of the countries with access to the Initiative in 2005, what was promised already in 1996 was not reached for nine years, namely a cancellation of all unsustainable debt. The most visible consequences of the creditors' understandable but foolish use of their sovereignty over the debt workout mechanism are the repeatedly adjusted definitions of "debt sustainability". The thresholds had almost always been ridiculously high. In lots of cases, the absurd result of this "debt relief" was that countries that had not been servicing their debts for a long time, took up paying again as a first step hoping that they would be able to establish normal relations with their creditors after the restructurings. In many cases they initially paid more than they had paid before the start of the initiative. The means to do so normally came from the international financial institutions themselves in the form of fresh loans, leading of course to more debt.

This failure of the initiative is no coincidence. It mirrors the basic defect of creditor-dominated debt management: the claim that a sustainable result can still be reached if one of the two parties functions as a judge in its own case. An in whatever way "reformed" Paris Club or a HIPC-Initiative working by the same rules as always can therefore not be a solution. A cartel of creditors can perhaps concede some generous gesture in favour of a debtor; it can however not provide all affected parties with legal security. That is exactly why an impartial decision making process is a basic principle of every constitutional order.

"We never did it like that …"

This is not totally true. When Indonesia was having trouble to service its debt in 1969, due to the complex creditor structure, where the USSR and western creditors were about the same size, no solution was in sight even though the country urgently needed a debt workout, a mediator was called, the German banker Herman-Joseph Abs. After a phase of travel diplomacy and talks with all parties, he presented a suggestion that intended a full repayment of the total capital and an almost complete cancellation of all interests. This was accepted by all parties and implemented. Until the Asia crisis in 1998, Indonesia had unrestricted access to the capital market.

"Arbitration processes are tedious and expensive."

That is at least not true insofar as arbitration processes are made use of as a cheaper and swifter alternative to a formal trial in lots of very different international disputes already and are a popular means of conflict resolution in the context of many international disputes that are not related to creditor-debtor-relations. In the concrete case of sovereign debt, ordinary courts can only decide upon the relation of debtors to a single creditor or a potentially single lawsuit of a collective group of similar creditors. Therefore, these courts aren't of great help anyway in bringing about debt sustainability with a great and heterogeneous group of creditors. Sure, in the case of complex debt and creditor structures the "taking of evidence" can take a while, but that wouldn't be different in the Paris Club – not to speak of the World Bank with its complex board voting procedures for a paper to get approval at the highest level.

"A SDWM will never be practical because of the mandatory requirement of parliamentary approval of all budget-related matters."

Parliamentary consent to individual restructurings is only required in a few jurisdictions, while in most cases, gov-

ernments can act under a blanket mandate. The parliament has the right to set up the budget but it cannot deal with individual transactions, which are mandated by the budget law. Just as providing individual loans is considered to be budget execution so is a restructuring or cancellation.

In those jurisdictions where parliamentary consent is in fact individually required for any debt restructuring arrangement, it may even be useful as it sets incentives to solve crises rather early than later and maybe it's not even too difficult to pass it through the parliament!

"A SDWM is not practical because countries that go through arbitration and receive debt relief will have a hard time getting fresh loans."

This is less an argument against a SDWM but rather one against debt relief in general. Still it lacks both logic and evidence: Logically, imagine a creditor who has only two possible clients, which happen to be identical states: one them being burdened by a huge amount of external debt, which absorbs any incoming resources immediately for servicing that old debt, and the other just having been relieved of an equal debt burden: who would this creditor actually lend to? Empirically, it can be noticed that any debt relief effort from the earliest Paris Club terms to Greece's latest rescue package have explicitly aimed at restoring the debtor's access to capital markets.

In most cases when this counter-argument has been raised, it has misperceived a sovereign loan as a friendly act by a benevolent person, who helps a poor cash-strapped debtor out. Such a friendly act would indeed have been informed by the debtor's repayment record in the past. Sovereign lending however, is a commercial transaction, which looks at the probability of future repayments, and which is charged with interest, that covers the unavoidable risk. The debtor's repayment record is only one (minor) factor guiding that decision.

"A SDWM is a good idea in theory but without the US, there won't be any progress, so at the moment there is no way forward for us to support a reform."

It is true that without or even against the US government progress is not possible to establish a SDWM in the IMF. For any other option outside the Bretton Woods institutions the US may be an important player but not one that could easily block a broader consensus if there is one. Had the 2014/15 process in the UN General Assembly received visible support from the EU plus, say, Japan and Canada, we would at least have an on-going meaningful consultative process in New York today. Whether an ad hoc agreement can be reached does not depend on whether the Us government is a creditor or not but will depend on the interests of creditors to seek a consensual agreement with the debtor and restore normal relations as quickly and as efficiently as possible.

"We've only just relieved poor countries from their debt burden. They are now the ones responsible to make sure that they don't take up too much new debt."

Nobody can "make sure" that they don't take up too much debt. First, because nobody can even know beforehand how much exactly is "too much new debt". Wherever there is a loan, there is also a default risk, be it large in a risky investment in a poor country or minuscule when you buy German "bunds". In any loan transaction both parties, debtor and creditor, therefore need to assess whether the loan is (too) risky for either of them and then decide accordingly. No historical debt relief eliminates this imminent challenge.

"It is more important to discuss the prevention of debt crises in the first place rather than discuss the resolution of future crises."

Responsible lending and borrowing are certainly important to avoid debt crises and any effort in this sense should be supported. However, any due diligence can at best minimize but not rule out the possibility of a debt crisis (see above). Thus, it makes no sense to state that crisis prevention is more or less important than crisis resolution. Rather, there are inter-linkages between the two approaches. Particularly in the present global financial situation

where capital over-supply in the Global North is the most important driving force behind the recent wave of loan-financing in the Global South, the credible threat that loose lenders run the risk of loosing their capital can have the greatest possible preventive effect against over-borrowing.

"Pacta sunt Servanda." (Latin for "agreements must be kept.")

This fundamental legal principle states that nobody has the right to arbitrarily disregard any contract he*she has ever signed with another party. It does not say that circumstances, which both parties have assumed in good faith at the time of signing cannot change. If for instance a family has taken out a loan from its local bank in order to buy a house and then looses the only income earner through a tragic accident, *pacta sunt servanda* does not cease to be a relevant principle; still, the circumstances will require, besides hardship for the family, most likely loosing the house, at least some partial loss to the bank. The final verdict by a judge would then consider also another legal principle, namely *rebus sic stantibus*, which means that commitments under a contract are unchangeable as long as relevant circumstances do not change.

"Commercial debt always has to be repaid."

No. In a normal creditor profile of a sovereign state, loans taken from private lenders (often banks) have historically often been the first category that underwent restructurings and eventually haircuts. In the so called "Third World debt crisis" public lenders, until the first poor country debt relief terms of the Paris Club in 1990, upheld that it was actually the other way round: public claims (ODA or publicly guaranteed export credits) were to be exempted from restructuring because this was "taxpayers' money". When due to unsustainable debt levels governments more and more undertook unavoidable debt reduction efforts, the "exempt creditor status" was restricted to multilateral public lenders. However, even this ceased with the HIPC/MDRI initiatives (see below).

The only private claims that for some time have been exempted during the modern debt crisis of the Global South, were sovereign bonds. However, this practice also changed when bonds grew in amount so that the restoration of debt sustainability became ever more difficult if they were left out. Finally, the Pakistan January 1999 agreement with the Paris Club was the first to request a "comparable" restructuring of sovereign bonds. Ever since, bond restructurings have been a standard element of debt restructurings where relevant.

An international insolvency framework would provide the option to seek a fair balancing of the interests of competing creditors - rather than an asset grabbing process under the law of the jungle.

"Debt relief will set the wrong incentives because it will let governments get away with being corrupt and wasteful."

The existing procedures behind the closed doors of the Paris and London Clubs have indeed made sure that the complicity of lenders with dictators like Zaire's late Mobutu Sese Seko or Latin American military regimes has not been an issue. Such questionable claims have normally been treated on equal footing with the most reasonable forms of development financing. An impartial and transparent process would for the first time provide the opportunity to hold the financiers of dictators and destructive projects to account.

"A SDWM will only lead to countries piling up debts and even more debts because in the end they will receive debt relief anyway."

Debtors can only "pile up debts" as long as creditors are willing to lend to them. Thus, we have a situation of shared responsibility from the beginning. The lender's decision to lend will be based on the individual assessment of the debtor and the conditions regarding interest, repayment terms and seniority, which the debtor offers. The existence of any orderly debt workout mechanism (which does not necessarily leads to debt relief) in and by itself is therefore not likely to be an incentive towards irresponsible borrowing and lending.

"The population is to blame! They are the ones that voted for their reckless governments."

If debt unsustainability has been the result of irresponsible behaviour on the part of the debtor government rather than hard luck in the form of, for instance, natural disasters or commodity price shocks, an impartially led debt restructuring is the best possible option to shed light on any individual responsibilities. The population of the affected country is not likely to be spared from the consequences of their vote (if there was any) because debt relief has rarely ever been 100 per cent, and economic problems are not automatically overcome with debt relief. Bad governance will have consequences way beyond sovereign debt questions.

"If you are over-indebted, you have to cut back your spending. Everyone knows that. Why should it be different for sovereign states?"

This is not entirely wrong, and hardly any sovereign has ever been in debt problems without cutting expenditures in one form or another. In this respect, austerity is most likely the option any government will use to avoid default long before they start any debt restructuring. As long as they do not save beyond the point where more saving only drags the economy further down, there is nothing wrong with that.

More importantly, however, is the other role that the state is playing with regard to economic development besides managing public finances responsibly. Public bodies are tasked with allowing the economy to prosper, which normally means allowing it to grow to some extent. For this purpose it may be necessary to provide fiscal stimuli for instance by creating public demand for labour and services. A public entity in debt distress will normally not be able to finance such a stimulus through its regular income (which is insufficient, otherwise the entity would not find itself in debt distress). Therefore, it needs to keep borrowing with the hope that the growing economy will bring the debt/GNI ratio back down by sufficiently enhancing the size of the whole economy or at least those parts of it that create the hard currency income, which is required for servicing the debt.

"They could just print more money."

Indeed, they could and some critically indebted countries just do so: The United States can do it because they print the world reserve currency, which would have to experience an enormous inflation before it would be abandoned as such by a substantial number of countries. Europeans indirectly do so when the European Central Bank buys sovereign bonds of EU members to the extent it takes to keep them fiscally afloat. Venezuela does it and creates hyperinflation, which adds to the economic breakdown after the collapse of the oil price and US sanctions.

The reason for Venezuela's and other comparable cases' fate is that they are not indebted in any currency they can print but one that is normally produced by its creditors or a third party. Printing pesos in such a situation will lead to depreciation of the peso against those currencies that are needed to service the debt. As a general rule, "inflating a debt away" is only possible for countries that are indebted in their own currencies. Others do not have this option inflation-free.

"How can you tell a country is in a debt crisis? Everybody could just claim they cannot pay and need debt relief."

Just claiming one is in crisis and needs relief is of no great help to anybody. Of course debtors can refuse to pay at any time. As a unilateral act this will then trigger economic or political retaliation in the form of impaired access to external finance or explicit sanctions beyond the public finance realm, which may have severe consequences for the debtor.

A fair and transparent insolvency framework commissions the analysis of the debtor's economic situation to an impartial entity, in which neither the debtors nor its creditors must have any stakes. Its analysis will then guide the decision, whether any relief is necessary or not.

Recent analyses of the debt restructuring history of sovereigns of all income categories has shown, that crisis management has been the more effective, the sooner steps have been taken. In most cases, it has also paid off for the creditors to get engaged at an early stage and incur limited losses rather then speculate that the crisis will somehow go away on its own. As a rule, such behaviour has boosted ultimate losses.

"But countries cannot go bankrupt."

Bankruptcy is the state where a debtor is not only temporarily but permanently unable to comply with its payment obligations. There is no logical reason why a sovereign debtor who takes out loans like any private debtor should not find himself in that same situation. For some time, creditors have suggested that sovereigns will always be able to extract the necessary resources out of its economies via taxation. However, it has never been convincingly explained why the capacities of an economy should be potentially infinite. On the contrary, there have been a few spectacular cases where presidents have tried to live up to that paradigm and found themselves quickly ousted - or even shot like Nicolae Ceaușescu, who literally starved and shock-frosted his population in order to continue servicing Romania's external debt.

"We have been fighting for a sovereign debt workout mechanism for such a long time. Is there really any chance that we shall ever see the system change?"

We as (Northern and Southern) debt movements are catalytic elements in a process towards a system change at best. Thus, we are not supposed to bring it about anyway. Rather, progress will depend on some economic and political facts and circumstances: first, the intensity of the debt distress, which debtors suffer and second, rifts between different creditor groups - such as those between creditors who are only interested in the highest possible return on their investments and those who wish to stay engaged, look at long-term profits and prioritize political and social stability over short-term returns. A situation where the debt distress is substantial and the latter perspective prevails among creditors is one where either an individual solution beyond existing insufficient procedures will be sought or a new global framework will be designed.

It were these kinds of conflicts plus a few strong debtor governments, who started to stand up for efficient debt relief plus - indeed - some catalytic conceptual work and social mobilisation by UN organisations and global civil society that broke the taboo of multilateral debt relief in 1996 and later with the Cologne Debt Initiative and the MDRI thereafter.

Later, the debt problems of a larger group of middle-income countries, which were not covered by the HIPC initiative combined with global insecurity and fear triggered by 9/11 came closest to such a set-up and consequently was the moment when the US administration allowed the IMF to work on the sovereign debt restructuring mechanism (SDRM) framework.

One should keep in mind that those paradigm shifts surfaced almost overnight, while creditors formally still upheld the old untenable doctrines.

"If creditors would benefit from a sovereign debt workout mechanism, why are they so opposed to it? What are the REAL reasons behind their position?"

The messy character of existing debt restructuring options makes a realistic assessment of what individual creditors have to gain or loose from an orderly process difficult. Therefore, decision makers are strongly incentivized to "kick the can down the road" hoping that they will still manage to get their money back before the debtor has to cease payments - as unrealistic as this may regularly be.

Creditors are to clearly benefit from a fair and transparent debt workout mechanism insofar as they (a) have economic or political long-term interests in the debtor country or (b) face the threat of finding themselves in a weaker position if a debt restructuring happens in a disordered and chaotic way, which allows some (less scrupulous) creditors to secure bigger parts of the cake at the expense of not only an overexploited debtor but also of other creditors.

“It is in the interest of rich countries to keep poor countries dependent by keeping them in debt. Why should they ever give up their power and agree on a SDWM?”

This was indeed a (very) informal argument raised by creditor government officials in the pre-debt-relief times, sometimes winkingly garnished with the supplement that, given poor governance in many debtor countries, creditor-led structural adjustment would be the best possible option for the debtor country's population, too. In fact, debt dependence of Southern sovereigns has been used to open their markets, enforce privatisations at sell-out prices and oust uncooperative governments.

However, such behaviour also came at a price for the creditor too: it delegitimized official development policy, kept brutal and cleptocratic regimes in power and, threatened eco-systems. We need to view creditors not as a coherent, imperialistic bloc but rather as a mixture of contradictory interests, some of which are totally destructive while others can play key roles in bringing about social and economic development including debt relief.

“There needs to be a seniority status (for instance for the IMF), a SDWM would challenge that.”

A SDWM does not necessarily rule out seniority among creditors. It does indeed start from the notion of equal treatment of all creditors. From there, however, it provides space for differentiations, for instance among those creditors who have financed meaningful development over those who were behind dodgy deals or of those who support debt restructuring through the provision of fresh money over those who just wish to rush to the exit.

The independent decision making process, which is at the heart of a SDWM, is best placed to reward all kinds of cooperative behaviour against all those who are not prepared to help resolving the crisis. What it would indeed not accept is the blanket exempt creditor status, which international financial institutions (and multilateral lenders at large) have been claiming before and after HIPC. As multilateral lending through most of the 1980s and 1990s has pretended debt sustainability while in reality it was already gone for good the international financial institutions claim that multilaterals were the lenders of last resort and their claims were therefore untouchable, did not make any economic sense at all. Quite the opposite is true: the claim that multilateral lending needed to be exempted from any market discipline gave the wrong incentive to lend into situations where no repayment could ultimately be expected. The huge write-downs of multilateral claims under HIPC and MDRI are strong testimony to this distortionary effect. An SDWM would finally make an end to such practice by strictly limiting seniority and would instead reward positive engagement of the respective creditor during the restructuring process.