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Author: Kristina Rehbein

Jubilee Germany / erlassjahr.de – Entwicklung braucht Entschuldung
Carl-Mosterts-Platz 1
40477 Düsseldorf
Germany
tel.: +49 (0) 211 / 46 93 -196
email: buero@erlassjahr.de
www.erlassjahr.de

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Action, not obstruction!

On the disappointing treatment of the new debt crisis of the Global South by creditors

Kristina Rehbein

The erlassjahr.de 2018 Global Sovereign Debt Monitor showed that the global debt crisis has arrived. For more than a year now, the International Monetary Fund (IMF) has also been ringing alarm bells. Unlike past debt crises, these alarm signals are not being ignored or denied by representatives of public and private creditors. Rather, it turns out that the civil society assessment of the debt situation of developing and emerging countries is shared among ministries of finance and creditor institutions. Unfortunately, that does not mean that those responsible are taking decisive steps to tackle the crisis.

1. Talking about the crisis is not enough

After the alarming data on the debt situation of the Global South, creditors and financial institutions are also coming to the realisation that many different countries are moving towards a new debt crisis. At the annual meetings of the IMF and the World Bank in Bali in October 2018, experts were in agreement on the magnitude of the emerging crisis: global debt was at record highs - in both rich and poor countries. The number of developing and emerging countries facing the risk of default had doubled in just a few years. One of the factors responsible for aggravating the crisis was surplus cash on the global financial markets in times of low interest rates, which had boosted lending to the Global South. External shocks, such as the collapse of global commodity prices between 2014 and 2017, had led to slower growth, lack of revenue and declining debt sustainability. The signals of a slowly ending low interest rate policy in the Global North, which is now leading to the outflow of capital from developing and emerging countries and which makes the refinancing of debt through new loans more expensive, increased the risk of the final outbreak of a debt crisis in the Global South. IMF analyses even show that it is unlikely that the foreseeable development in critically indebted countries will disappear on its own, i.e. without debt relief.[1] At the same time, experts agree that the debt structure of developing countries became more complex. The comprehensive creditor coordination, which is necessary to overcome a crisis, could not be achieved with the existing mechanisms. Also, the *Collective Action Clauses*[2] (CACs), which were presented by rich creditor governments for a long time as the only necessary innovation for better resolving sovereign debt crises, were not sufficiently contributing to tackling this crisis. And some experts have agreed that it was becoming apparent that the current debt situation had already become an obstacle to development.

It seems that - unlike in the past - creditor institutions publicly share the positions of civil society debt justice organisations before the first debt defaults lead to a widespread system crisis. First of all, this is a good sign when compared to the course of the so-called "Third World Debt Crisis" of the 1980s. At that time, the crisis was denied by public bilateral and multilateral creditors, particularly the IMF, also through far too optimistic debt sustainability analyses, until the multilateral debt relief initiative for heavily indebted poor countries was created many years after the onset of the debt crisis.[3] Limited debt restructuring options in the Paris Club, which

[1] See IMF (2018): "IMF Policy Paper: Macroeconomic Developments and Prospects in Low-Income Developing Countries - 2018", p. 48, pt. 76.

[2] *Collective Action Clauses* are agreements in bond contracts that can help facilitate debt restructuring negotiations of sovereign bonds. They allow the majority of buyers of a particular bond to force the minority, by their vote, to agree to a restructuring agreement with the issuer of the bond (the debtor country).

[3] See, inter alia, Woodward, D. (1996): "Debt Sustainability and the Debt Overhang in Heavily-Indebted Poor Countries: Some Comments on the IMF's View", in: World Credit Tables - Creditors' Claims on Debtors Exposed, EURODAD, p. 29-43; Baker, D. and D. Rosnick (2003): "Too

always proved insufficient after a few years and needed to be improved again and again, have been repeatedly presented as the ultimate solution for over-indebted countries. As a result, there was no sound basis for an open discussion on the timely and adequate resolution of the Third World Debt Crisis. The result was a year-long crisis with dramatically high costs for the social and economic development of debtor countries.

But is there hope today for a different outcome, when, unlike in the past, the creditor institutions seem to have a more visible awareness of the seriousness of the situation?

2. Remaining stuck

Unfortunately, there is not much indication for this. Instead of acting promptly, the creditor countries and experts of the international financial institutions are rather discussing the weak administrations and irresponsible debt policies of some poor countries in a way, as if they were the central threat to global financial stability. Instead of working out concrete steps to deal with the looming crisis, they remain stuck on their course, set many years ago, that with some preventive measures, the next crisis could be avoided.

They are acting like a firefighter, who is in the right place at the right time, but does not make sure that the fire is extinguished and people are saved.

2.1. Debt transparency, wonder weapon?

Preventive measures that are being discussed in the IMF and World Bank "multipronged approach for addressing emerging debt vulnerabilities" include, for example, better debt management in debtor countries[4], more thorough and realistic IMF debt sustainability assessments for faster detection of crises[5] and greater transparency in regards to debt data[6]. Especially the latter is a currently popular discussion, which is due to the debt scandal in Mozambique[7] and other "hidden debt" cases. As was the case with the inclusion of CACs in bond contracts since 2013, data transparency is now being discussed as the new miracle weapon in the prevention and resolution of debt crises.

Behind this is the consideration that debt sustainability risks are inadvertently underestimated by a patchy data situation. Complete information on the current debt level is therefore seen as the key to better debt sustainability analyses and therefore to an appropriate assessment of debt distress risks. Consequently, a halt

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Sunny In Latin America? The IMF's Overly Optimistic Growth Projections and Their Consequences", Centre for Economic and Policy Research. In Bali at the annual meetings of the IMF and the World Bank, an IMF official admitted that the often too optimistic calculations and forecasts were responsible for the delays in debt crisis resolution; see IMF and World Bank Transcript on *Civil Society Policy Forum* (CSPF) Event (2018a): "Too Many Cooks: Addressing Evolving Creditor Coordination Challenges in Sovereign Debt Crisis Resolution", pp. 19-20, pubdocs.worldbank.org/en/102211548257983978/18AM-CSPF-11-00-Bandung-101218.pdf.

[4] See, among others, "Debt Challenges Ahead" World Bank panel discussion on the 13th of October, 2018 in Bali, Indonesia, IMF and World Bank (2018): "G20 Notes on Strengthening Public Debt Transparency", "World Bank/IMF Annual Meetings 2018: Development Committee Communiqué", AfDB, IMF and World Bank (2017): "The G-20 Compact with Africa - A Joint AfDB, IMF and WBG Report, G-20 Finance Ministers and Central Bank Governors Meetings, 17-18 March 2017, Baden-Baden, Germany" , p. 8f.

[5] See, inter alia, Mühleisen, M. and M. Flanagan (2019): "Three Steps to Avert a Debt Crisis", IMF Blog.

[6] See, inter alia, Panel discussion of the World Bank on 13.10.2018 in Bali, Indonesia; "The Charlevoix G7 Summit Communique", Pt. 7, 09.06.2018; IMF and World Bank (2018): "G20 Notes on Strengthening Public Debt Transparency"; IMF (2018); Jha, L. K.: "IMF, World Bank must develop strategy for enhancing public debt transparency: India", 21.04.2018: livemint.com/Politics/kWMnkV270ELKveLyUxEGuJ/IMF-World-Bank-must-develop-strategy-for-enhancing-public-d.html.

[7] For more information on the debt scandal in Mozambique, see Kaiser, J.: "Mosambik: Ein Land unter dem Ressourcenfluch", in erlassjahr.de and MISEREOR: Schuldenreport 2017.

could be called much earlier, in the case of a debt level becoming critical. One such “emergency brake” is the *Debt Limits Policy* of the IMF, which sets out how much debt a country can sustainably carry depending on the risk of debt distress, and which sets a debt ceiling, especially for non-concessional loans.

Full debt data, say experts, is the basis for more responsible lending. Transparency was therefore the key to crisis prevention.[8] How else should creditors know how much debt is too much debt? an IMF official asked during the annual meetings of the IMF and the World Bank in Bali in October 2018. Some even argue that avoiding "surprises" (i.e., the sudden emergence of claims from the debtor governments that were not previously recorded as such or deliberately kept secret[9]) would naturally lead to timely and orderly debt restructuring negotiations, which implies that there is no need to discuss more far-reaching reforms than better data transparency to tackle debt crises.[10]

2.2. Delaying tactics

Of course, better-functioning administrations and better data are essential steps and measures to improve both should be taken. But they are not sufficient, neither for the resolution of crises nor for their prevention. A transparent creditor structure alone does not increase their willingness to participate in negotiations or to cancel debt to a sufficient extent. Studies by independent institutions and the IMF itself show that in the past, debt relief negotiations were neither timely nor efficient or orderly, but characterised by systematic and deliberate delaying tactics. Debt relief then often came too late and was not extensive enough to sufficiently restore a country's debt sustainability. This left creditors and debtors trapped in recurrent debt rescheduling and cancellation operations.

The implicit assumption that creditors always act in good faith and for the benefit of the debtor's debt sustainability inevitably means that the only logical policy reform measure is to strengthen the data-gathering administration of the debtor country. This contradicts, however, the observation made elsewhere by experts of financial institutions and industrialised countries that there are insufficient processes for creditor coordination in the coming crisis, and the widely expressed concern that this debt crisis will be marked by many "difficult", "complicated" and "uncooperative" creditors.

Another problem with the discussion about greater debt transparency is that it implies that the problem to be solved lies solely in an inadequate debtor discipline. The creditors' responsibility for the emerging debt crises is being neglected. But a realistic analysis shows that the build-up of the current debt crisis is not due to the fact that creditors' lending decisions were forced to rely on false assumptions about the solvency of the debtor due to lack of data. The crisis was caused rather by the fact that Creditors simply did not care, when the respective debt burden had exceeded an unsustainable level, and because the “emergency brakes” of IMF and World Bank hardly worked.

For example, the IMF rated the debt distress risk of Ghana as "high" in 2015. Only a short time later, the World Bank guaranteed $400 million in debt service to private holders of a high-yielding government bond so Ghana could successfully place the bond. To the already dangerously high debt level of the country was added another

[8] See, inter alia, The Institute of International Finance (IIF) (2018): "Debt Transparency Initiative - Background Note"; IMF and World Bank (2018): "G20 Notes on Strengthening Public Debt Transparency", p. 49, pt. 5.

[9] Examples in IMF and World Bank (2018), p. 15.

[10] See World Bank panel discussion on 13 Oct. 2018 in Bali, Indonesia (see Statement by Eric Lalo, Managing Director of the *Lazard Sovereign Advisory Group:* "Data transparency is a fundamental element, if you want to have a quick, efficient, orderly restructuring. […] Know your creditors. It is absolutely imperative that countries [...] know who their creditors are. […][…] The worst thing that can happen is that a restructuring is lasting and lasting forever. If you know your creditors and you can alert them, you can prepare necessary approaches, you can go fast."

billion US dollars with an unusually high interest rate of 10.75 percent. To this end, the World Bank circumvented its own rules that normally forbid to issue credit guarantees when the debt sustainability of a country is no longer secure.[11]

The head of the IMF, Christine Lagarde, said in an interview that creditors, in the frenzy of lucrative return promises, preferred to refrain from serious credit risk assessments in order to push as much loans as possible on the African continent: *"What I know for sure - because we've had programs with some of them (African countries, author's note) - is that the lenders were so eager to lend that I don't think they were very serious about assessing the risk and assessing their exposure. And there was clearly, on the part of some investors, in the private sector in particular, a drive to push as much debt as possible in order to generate some yield."*[12]

What remains unacceptable about the important debate on crisis prevention is that it has been used by creditors to politically undermine a comprehensive reform of the processes for dealing with debt crises. In the past, the meaningful but limited instrument of the *Collective Action Clauses* had to serve for that cause, today, it is the discussion about debt transparency. Prevention may be important to make debt distress situations less likely. But when a crisis is rampant, rapid and sufficient policy action is needed to terminate it.

2.3. Contradictory attitude of creditors

So what should be done if, despite all efforts of prevention, indebted countries need to cease debt service payments? Basically, the IMF, World Bank, Paris Club and private creditors agree that dealing with defaults in the Global South has become "more complicated" due to significantly differentiated creditor profiles. The IMF in particular underlines the problem that, given the diverse and fragmented creditor landscape, there are no common rules and processes for the coordination of creditors in the case of a debt crisis.

From this perspective, the following factors contribute to the differentiation of the creditor landscape:

- Significant bilateral public lenders, particularly the People's Republic of China, are not part of the Paris Club and are not committed to the rules of the informal creditor cartel, which was created to negotiate collectively with its debtors. Therefore, such "traditional" mechanisms are described by the IMF as inadequate, as the share of claims from public bilateral creditors organised in the Paris Club is diminishing in the total debt of poorer developing countries.

- New donors are emerging, not bilateral or multilateral, but somewhere in between: to demarcate them from his own multilateral status, the IMF calls them "plurilateral donors". These include, for example, the *New Development Bank* with only 5 member states. Whether and how exactly these donors would reschedule or even cancel debt in a sovereign insolvency case, and how those donors would assess their "right" to preferential treatment, which otherwise would be claimed by the IMF, World Bank and other traditional multilateral institutions, is unclear.

- Although many sovereign bonds already contain CACs, most concern only one bond. This increased the incentive for creditors not to participate in debt restructurings (so-called *holdouts*). Since 2013, improved CACs had been promoted that tie together all or at least several individual bonds in a single voting and decision-making process; however, many government bonds that are at stake in this crisis had not yet included these enhanced CACs. There are also some sovereign bonds that do not contain

[11] See Jones, T. (2016): "The Fall and rise of Ghana's debt – how a new debt trap has been set", Jubilee Debt Campaign, jubileedebt.org.uk/wp-content/uploads/2016/10/The-fall-and-rise-of-Ghanas-debt_10.16.pdf.

[12] Gardner, T. (2017): "Africa's mounting debt crisis will worsen if US and Europe's economies improve, says IMF's Lagarde", qz.com/africa/1159245/imfs-christine-lagarde-says-africas-debt-burden-could-get-worse-if-us-dollar-and-euro-strengthens/.

any CACs. Therefore, holdout problems in the future can not be ruled out.

- A more recent phenomenon is asset-backed lending, including by private creditors, which raises the issue of equal treatment of creditors in restructuring processes. For example, the Republic of Congo and Chad have signed loan agreements whereby debt service payments are secured by the oil revenues of the two countries.

According to the IMF, in view of these challenges, none of the existing options, such as the coordination of the group of creditors by the largest donor, guarantees an efficient and timely solution. There is always the danger that creditors will not participate and consequently block a reasonable solution.[13] In the absence of processes that would bring together the different creditors and claims, debt restructurings would be slower and entail high costs for creditors and debtors.[14]

Civil society has also always considered a lack of comprehensive creditor coordination as one of the central problems for orderly debt crisis resolution. Could the obvious need for better creditor coordination processes in this upcoming crisis not provide the opportunity to reopen the debate on sovereign debt restructuring processes, as erlassjahr.de and others have long called for as a fundamental reform of the international debt regime?

If you ask political decision makers, you will get various, sometimes contradictory answers, including the following:

- According to the World Bank and European governments, the situation was, after all, not that dramatic, a crisis can undoubtedly still be avoided.[15]

- From the point of view of the IMF and many industrialised countries, the financing model of the international financial institutions does not allow this discussion, since multilateral debt always has to be repaid.[16]

- According to the World Bank, the IMF and the private sector, the situation has simply become too complicated: without a sovereign bankruptcy process that brings together all creditors, the IMF says it is difficult to reach an agreement with so many different creditors.[17] From the point of view of the private sector, it is precisely such a diversity of creditors that makes it more difficult to create a sovereign insolvency procedure to improve creditor coordination.[18] And according to the World Bank, the uncertainty about what to do in the next debt crisis with all these complicated new debts is simply frustrating.[19]

- European governments are of the opinion that debt relief would not work anyway as poor countries would immediately take on new debt. Maybe they would then knowingly even contract a higher amount

[13] See Transcript for the CSPF Event (2018a), p. 6.

[14] See IMF and World Bank transcript on the CSPF Event (2018b) "Financing Climate Change without Contributing to Debt Crises", pp. 3-35, pubdocs.worldbank.org/en/821161548257981889/18AM-CSPF-09-00-Bandung-101218.pdf.

[15] See, inter alia, World Bank panel discussion on 13.10.2018; also informal talks with government representatives.

[16] See inter alia transcript for the CSPF event (2018a), p. 9; Council of the European Union (2015): "EU common position on the UN draft resolution A/69/L.84 on ‚basic principles on Sovereign debt restructuring processes", p. 5.

[17] See transcript of the CSPF event (2018b), p. 34; Bredenkamp, H., et. al (2018): "Chapter 9: Challenges Ahead", p. 26, in: Sovereign Debt: A Guide to Economists and Practitioners, unpublished.

[18] See statement by the IIF representative at the CSPF event (2018a), pp. 19, 22 and 34 and statement by a representative of the legal consulting company *Clifford Chance* at a conference on the topic of Africa's debt by the *Overseas Development Institute* in December 2018, cited in Herman, B. (2018): "Doable Proposals and Yet Another Debt Conference", unpublished.

[19] See statement by the World Bank managing director at the World Bank panel on 13.10.2018.

of debt in order to benefit from debt relief.[20]

- The Paris Club and European governments are of the opinion that it would be better to do everything right now to ensure more sustainable and responsible borrowing and lending in the future. Prevention is the key![21]

- According to the IMF, there is currently just no political will ("there is no appetite") to discuss more far-reaching systemic reforms to tackle debt crises, especially sovereign bankruptcy processes.

On the one hand, the creditors, with reference to the complexity of the political negotiations necessary for debt restructurings, refuse any discussion about a sovereign bankruptcy process for dealing better with the debt crises. At the same time, however, their statements elsewhere suggest that the reopening of the discussion regarding precisely such processes is more necessary than ever. As private sector as well as IMF representatives stated, protracted debt crises were a "bad"[22] and "expensive"[23] scenario for all those involved and the creditors' coordination was so complicated precisely because there was no rule-of-law-based, multilateral sovereign bankruptcy process.[24]

2.4. The political will is missing - in the industrialised countries

The IMF's assessment that there is currently no political will for a systemic reform explains the contradictory or flimsy answers, especially from creditors, whose vested interest does not involve writing off their claims against the debtor. Ultimately, there is a lack of political will on all sides to resume the discussion about state bankruptcy processes.

However, a few years ago there was a great political interest on the part of developing and emerging countries. The G77, the alliance of 134 developing and emerging nations in the United Nations, attempted to launch an intergovernmental process at the United Nations General Assembly in 2014 to establish a multilateral legal framework for debt restructuring processes to address the issue of creditor coordination as a whole. At that time, it was the industrialised countries that actively blocked the negotiation process, among the German and many European governments. Speaking to German decision-makers today - against the backdrop of the looming debt crisis - about this process and their own blocking role, they reject political responsibility and declare that the US and Great Britain are the ones who, as important financial centres, are blocking any steps towards a comprehensive state bankruptcy procedure.

2.5 Insistence on inadequate structures - the Paris Club

According to the IMF, the most obvious reform option is currently the expansion of the Paris Club.[25] This refers mainly to winning the People's Republic of China as a member. The principal function of the Paris Club is to coordinate and safeguard the creditor interests of its current 22 members, most of them traditional industrialised countries, also members of the OECD. As they lose importance as bilateral official creditors in developing countries, their interests are threatened by more significant donors, such as China, who can take

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[20] Statements by IMF European executive directors in conversation with civil society on 10/10/2018 in Bali (unpublished minutes).

[21] See above and statement by the Vice-Chairman of the Paris Club at the CSPF event (2018a), p. 13.

[22] See statements by Lazard Sovereign Advisory Group representative at the World Bank panel discussion on 13/10/2018.

[23] See statement by the IMF representative at the CSPF event (2018b), p. 34.

[24] See Bredenkamp, H. et. al (2018).

[25] See statements of the IMF representative at the CSPF event (2018a), p. 5 and 6.

care of their own creditor interests. Therefore, there is a great desire to win China as a member of a club whose supreme command is the solidarity among themselves. If China were included in the cartel, club members would have a strong influence on what is currently the most important bilateral creditor in many developing countries. Even the IMF, which has so far proved to be the most rational voice on the creditors' side in the emerging global debt crisis, surprisingly presents the piecemeal question of adding another member to the Paris Club as a key reform to overcome the current global debt crisis. The Fund acts just as disappointingly as the World Bank, which in the 1990s was the courageous pioneer of the multilateral debt relief initiative for heavily indebted poor countries. Even on the contrary, the World Bank contributes to the build-up of the current crisis by its support for loan pushing, meaning serious initiatives for improved crisis resolution should not be expected from the Bank.

Obviously, the extension of the Paris Club to include some official bilateral creditors (most recently Brazil and South Korea) does not solve the problem of fair burden sharing among the different categories of creditors. Instead of taking action, the various actors are blocking the debate on a sufficient political solution: the Paris Club refers to the "Paris Forum" created in 2013, an annual conference on various aspects of debt management, which is intended to serve the mutual rapprochement of debtors and public and private creditors, but otherwise the Paris Club is at a loss, pointing to the "complexity" of the problem.[26] The private sector points to voluntary principles that can contribute to more efficient debt restructurings, but also stresses the complexity of the situation.[27] Finally, the IMF would like private creditors to stick to their debt limits imposed on the debtor, but shares the view that otherwise it would be very complicated.

3. What needs to be done now

Observers familiar with the "Third World Debt Crisis" of the 1980s are currently witnessing a collective resistance to learning. At that time, delaying tactics to avoid a long-term unavoidable debt cancellation were a common strategy. Those responsible in rich countries and international financial institutions simply did not acknowledge the apparent crisis until they could no longer choose to deny it. The protraction had turned a financial crisis into a humanitarian disaster for the people in the affected countries. Some brave World Bank employees (and lots of insisting activists) were needed to put an end to this crisis by creating the *Heavily Indebted Poor Countries Initiative* (HIPC).

Although the crisis today is being acknowledged, there is still a lack of political action. Already the urgently needed debate about adequate solutions is missing. The refusal to act will allow a repetition of the disaster of the 1980s and 1990s. The discourse on prevention and transparency serves as a cover for pathological delaying tactics. Because even the most sensible prevention measures can never completely exclude a situation of debt distress.

However, the bemoaned diversity of creditors currently offers the opportunity for a paradigm shift in the discussion about adequate debt crisis management as well as the operationalisation of the joint responsibility for debt sustainability recognised by the G20 countries in 2017 under German presidency.[28] Development partners and international financial institutions have a common interest with the debtor country, which it has to defend against those creditors they call "uncooperative" and "complicated". A courageous step could be to go beyond creditor solidarity and strengthen those directly affected by the crisis — the debtor countries.

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[26] See Paris Club Vice-Chairman at the CSPF event (2018a), p. 15.

[27] See the representative of the IIF at the CSPF event (2018a), p. 17-19.

[28] See "G20 Operational Guidelines for Sustainable Financing".

Specifically, this could mean the following political reform measures:

- Political support for the resumption of United Nations negotiations on a comprehensive multilateral legal framework for debt restructuring.

- Political support to debtor countries in a specific crisis situation in the ad hoc organisation of early and comprehensive debt relief negotiations.

- In addition to raising awareness on IMF debt limits by improving the exchange of information, irresponsible lending could be sanctioned by excluding loans from repayment, that exceed a set debt limit.

However, such reform steps require governments not to (any longer) see themselves as administrators of the interests of private and public investors, but to make decisions primarily in the interest of global financial and social stability. The multilateral debt relief initiative for heavily indebted poor countries twenty years ago was a rare moment when governments at that time were ready for such an effort. These efforts have been rewarded with an economic restart and cautiously successful democratisation in some of the beneficiary countries.