PERSPECTIVE

ECONOMY AND FINANCE

SOVEREIGN DEBT RELIEF AS A GLOBAL POWER ISSUE

A Political Economy Analysis

Jürgen Kaiser
March 2021

The Debt Service Suspension Initiative (DSSI) created by the Group of 20 (G20) to overcome the sovereign debt crisis triggered by COVID-19 will not enable the affected countries to make a fresh start.

The DSSI does not redress the fundamental power imbalance between debtors and creditors, but rather perpetuates it. Debt relief cannot be enforced against the will of powerful creditors.

Unlike the G8 and the debt relief initiative for Heavily Indebted Poor Countries (HIPC), consensus is blocked by the many conflicting interests within the G20 regarding the measures needed.

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The COVID-19 pandemic has triggered a global recession that is bringing ever more countries to the brink of insolvency. International financial institutions, major creditor governments, including the German Federal government, and the global debt relief movement agree that far-reaching debt relief will be necessary for a large but as yet undetermined number of countries if the poorest countries' fiscal collapse is to be prevented from also becoming a social, and eventually a political, conflagration with unforeseeable consequences.

Faced with this situation, the G20 and the international financial institutions fairly quickly adopted practical debt relief measures, namely the Catastrophe Containment and Relief Trust (CCRT)[1] and the Debt Service Suspension Initiative (DSSI).[2] However, these pragmatic innovations do not address fundamental issues regarding debtor-creditor relations, meaning that many assumptions that have shaped debt management in past crises may well go unchallenged.

This study identifies and discusses some of these assumptions in the hope that this crisis will provide the opportunity to develop more equitable and efficient solutions for this and future crises.

THE HISTORY OF DEBT RESCHEDULING

STATE OVER-INDEBTEDNESS IS A RECURRING PHENOMENON

What is most remarkable about the numerous sovereign debt crises of the recent past, such as the »Third World debt crisis« in the 1990s, Argentina's bankruptcies in 2002 and 2019, as well as the Greek crisis, is that they were regarded as *surprising*. Apparently, policy-makers, creditors and commentators all assumed that sovereign debtors do not really *default*. The impression was created that when poorer states began to have new difficulties soon after their debt had been restructured, the borrowing government must have behaved irresponsibly.

In fact, any loan brings with it the risk of default.[3] Such risks increase in proportion to the debtor state's institutional weakness, relative poverty and other factors. This is why poorer states pay higher interest rates on their debt securities than richer ones.

1 The CCRT assumes participating countries' current debt service payments to the IMF, thereby relieving their national budgets.

2 The DSSI allows a limited group of up to 73 countries to postpone their current debt servicing to G20 and Paris Club members for up to three years.

3 This is also true for »AAA« securities like German Federal bonds. In the – thankfully unlikely – case of numerous nuclear power plants simultaneously having unimaginable disasters, the ratings of the Federal Republic of Germany would also drop, making chances of repayment less secure than at the time they were sold.

INTERNATIONAL LAW DOES NOT GOVERN THE ORDERLY INSOLVENCY OF DEBTORS

Although history shows that state bankruptcies are a recurring phenomenon, international law does not address the problem. The only binding rule under international law is the principle that »agreements must be kept«. But when a debtor cannot fulfil its obligations under realisable and reasonable conditions, this principle has limited applicability.

This is why all the procedures used to restructure debt are informal. They are either ad hoc agreements between a debtor country and an individual creditor or between a debtor country and a group of private creditors in an informal forum: the London Club has been used by the major commercial banks on a case-by-case basis, while the informal Paris Club has been organised by state creditors in order to meet with a country in financial difficulties when it comes to rescheduling debt or agreeing debt relief. Most Club members belong to the OECD and/or the G20.

Legal certainty only emerges from such informal negotiations if national jurisdictions can enforce their outcomes. Competent courts are very rarely located in the debtor country and usually are based in cities like London or New York. However, the courts' enforcement power is limited because debtor countries generally have no or very few assets outside their borders that can be seized to satisfy creditor claims on the grounds of an enforceable title. Furthermore, even if international agreements exist, the debtor's domestic laws regularly prevent their enforcement.

Nevertheless, voluntary arrangements are made if both sides expect them to be more advantageous than no agreement at all. This is true for questionable arrangements such as the numerous Paris Club debt rescheduling agreements for the poorest countries under the seriously flawed »classic terms«[4] as well as successful ones like the 1953 London Agreement on German External Debts for the young Federal Republic (cf. Kaiser 2013a) or the debt relief that the Paris Club granted Indonesia in 1969 as a result of mediation (cf. Hoffert 2001).

TWO LEVELS OF CONFLICT

Negotiations, which are of necessity organized on an ad hoc basis between the debtor and one or more groups of its creditors, must resolve conflicts with two dimensions:

- Creditor versus debtor interests and
- Claims coordination and possible burden-sharing by different creditors or groups of creditors

4 The Paris Club uses certain standards for restructuring that were developed in previous cases: »classic terms«, »Houston terms«, »Naples terms« and »Cologne terms«. See https://clubdeparis.org/en/communications/page/standard-terms-of-treatment.

The usual starting point of debt rescheduling negotiations is a state's inability to meet its payment obligations to foreign creditors. That triggers a suspension of payments, which is followed by the renegotiation of payment obligations. Restoring solvency does not just require two-party negotiations, but also talks between the debtor and a possibly very diverse group of creditors.

In this case, the conflict of interest between the debtor, who wants to pay as little as possible, and any creditor, who wants to get as much as possible, is relatively clear. However, when dealing with many different creditors and creditor groups, the situation requires elaborate coordination. The following section therefore presents the various types of possible creditors and creditor groups and shows how their respective constellations affect the prospects for success of debt restructuring proceedings.

THE MAIN TRENDS REGARDING PUBLIC DEBT

THE RISE OF PRIVATE VERSUS PUBLIC FINANCING

The policies of the International Monetary Fund (IMF), like the general debate about development finance, have long been shaped by the norms of liberal hegemony. Unleashing economic potential by dismantling financial market regulations was considered to be the most effective way to finance development. In the field of development policy, however, there are now two fundamentally contradictory paradigms regarding the relationship between public and private financing. The central question is whether private financing is key to achieving international development goals – with public financing merely used as a catalyst – or whether development financing should, as a matter of principle, be controlled by public actors who can decide on the investment priorities. This is the fundamental issue regarding debt rescheduling.

Advocates of private financing insist that the magnitudes needed to achieve the Sustainable Development Goals (SDGs) are greater than the current capacity of Official Development Assistance (ODA) to mobilize funds. The argument primarily aims at improving investment conditions for private capital. It is often pointed out that in recent years, countries in the Global South have increasingly raised funds for development financing on the private capital market. However, private capital flows to the Global South do not match funding needs. These have always been high. In fact, to combat the recession triggered by the 2008 Lehman bankruptcy, major central banks instituted loose monetary policies and flooded capital markets. A large wave of lending to the Global South began. Financial market players, who had major payment obligations to their own investors and lenders, bought high-yield sovereign bonds from countries in the Global South, seeking to generate sufficient returns on capital although domestic interest rates had plummeted.

This is why governments in the Global South are not mainly responsible for the debt build-up, which is now giving rise to the next wave of defaults due to the COVID-19 recession. While it is true that often governments did not carefully handle the enormous amount of credit on offer, the primary blame lies with creditors who pumped cheap money into fragile economies and often equally fragile political systems.

FROM BANK LOANS TO BOND FINANCING – AND BACK AGAIN?

At first, the »Third World debt crisis« that erupted when Mexico defaulted in August 1982 was a conflict between US, European and Japanese commercial banks and middle-income countries in Latin America and, to a limited extent, Africa and Asia. Banks had lent money to these countries on a grand scale during the period of low interest rates in the 1970s. At the time, only a limited number of creditors was involved. In most cases, fewer than 10 banks had syndicated loans (involving other banks). Syndication also meant that the creditor side was fairly well organized and able to act. In each case, one lead bank spoke and negotiated on behalf of the syndicate it had put together.

This changed at the end of the 1980s, when the increase in the number of financial market instruments and the expansion of the funds they mobilized led to a relative decline in the share of banks that lent to the Global South, as Figure 1 illustrates using the example of lending to Latin America and the Caribbean (LAC). Bank loans were replaced by bonds as the major financing instrument. The latter differed from the syndicated bank loans in two crucial respects: They were often traded on highly liquid secondary markets where they changed hands quickly and sometimes in large quantities without being detected by market observers. Secondly, they could be sold to the general public, including the often cited Italian grandmothers who became creditors of the State of Argentina and were clobbered when the country defaulted in 2002. Of course, the vast majority of bonds were still in the hands of big players like insurance companies and mutual funds. But the plight of pensioners was invoked to challenge the legality of suspending payments in an effort to persuade national governments to either pressure Argentina or to come to the aid of both grandmothers and big investors.

The shift from bank loans to bonds is by no means a recent phenomenon, however. In the late 19th and early 20th centuries, the preferred instrument for exporting European and US capital to the South American continent were public bonds issued by Latin American states. A renewed increase in classic syndicated bank loans can be observed in many regions – not least because bonds have lost their privileged status and have since been included in debt rescheduling. It can be assumed that in low- and middle-income countries, both instruments will continue to be used for investing. For this reason, today's debt restructuring procedures have to find an efficient way to also include both public bonds and syndicated bank loans.

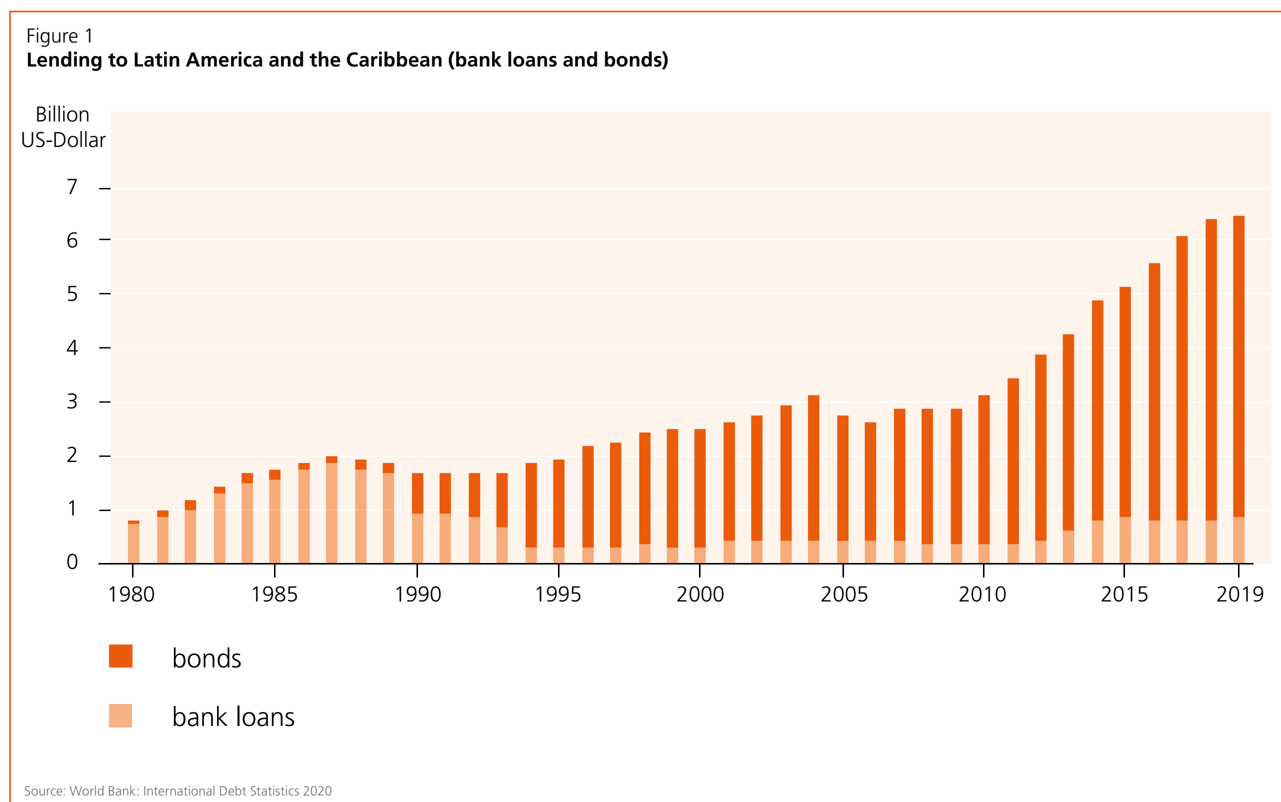


Figure 1
Lending to Latin America and the Caribbean (bank loans and bonds)

Source: World Bank: International Debt Statistics 2020

Of course, when it comes to restructuring a sovereign debt stock including through investing public funds it's much easier to co-ordinate a handful of banks on the creditor side than a large number of investors scattered around the world. In the latter case, it is impossible to foresee whether a majority of creditors will agree to such a deal. Today, big solutions like the »Brady Plan«[5] of March 1989 are no longer possible. That plan allowed the public sector to know in advance how much public money an operation would cost, how much it would contribute to restoring the solvency of the countries concerned and thereby help to increase global stability.

What's more, today highly liquid instruments like government bonds make it easier for aggressive investors – »vulture funds« – to buy up the distressed debt of countries at big discounts in order to then sue for full settlement plus interest and fees in the respective legal jurisdictions. (For more on vulture funds, see Kaiser/Geldmacher 2014.)

MULTILATERALIZING PUBLIC CLAIMS THROUGH CRISIS FINANCING

The special mandate of the international financial institutions and their preferred creditor status is due to their mission to prevent state bankruptcies by providing affordable multilateral funds. Although only the IMF is legally mandated to do this, during the crises of the 1980s, the World Bank changed from being a development financier to a crisis financier, and smaller regional multilateral development banks followed suit. This had negative consequences for institutions and borrowers: The quality of financing generally declined because an ever-larger share of the bailout[6] was overtly or covertly used to bail out the original bilateral creditors. Indebted countries, who had already struggled to obtain meaningful debt relief from their bilateral creditors, discovered that an ever larger part of its debt was owed to multilateral financial institutions, who insisted that their claims had to be serviced no matter what.

Only the rigid cancellation of multilateral claims in explicit disregard of the creditors' privileged status through the debt relief initiative for Heavily Indebted Poor Countries (HIPC) of 1996 and the Multilateral Debt Relief Initiative (MDRI) of 2005 reversed this trend.

In November 2020, it is not possible to predict if the reactions of various creditor groups to the crisis financing and relief needs of countries in trouble due to the pandemic will lead to a similar push towards multilateralization. We are already seeing a significant expansion of allocations of multilateral public funds, while private creditors choose to not participate in debt relief but rather are cashing in and leaving distressed countries. In 2009, there was an effort to

5 The plan was developed by US Treasury Secretary Nicholas Brady and his Japanese counterpart Yoichi Miyazawa in response to the Latin American and Asian debt crises of the late 1980s. Basically, creditors swapped their claims on indebted countries for bonds with a lower nominal value that were backed by the US Treasury. In other words, they exchanged their volume of claims for collateral in a situation that was critical for the banking system.

6 Here, »bail-out« means that the original bilateral creditors benefited from ongoing debt servicing through new loans provided from multilateral sources. Since the original creditors were hesitant to grant new loans to distressed countries, multilateral funders gradually became the most important – or sole – creditors of countries in crisis.

counter such developments in the form of the »Vienna Initiative« – an agreement between multilateral institutions and the private sector to voluntarily prevent sudden capital outflows from Eastern European countries that were in trouble due to the excessive liberalization of their banking systems after the collapse of the Eastern bloc.[7] In 2009 and 2010, the initiative worked quite well with respect to the payment difficulties of some Eastern European countries, albeit for only a small group of banks and countries. In Greece, on the other hand, it failed completely.[8]

THE DECLINE OF CONCESSIONAL DEVELOPMENT FINANCE

Developing and emerging countries' concessional funding (low interest rates and long repayment periods) have always been very small compared to their total debt. Two recent trends have caused it to shrink even more. One is that the growth of donor country development cooperation budgets has lagged behind the growth of the global economy and the recipient countries' debt. The second is that the potential recipients are more diverse. Experience has shown that even low-interest loans can create an unacceptable burden for public budgets and that the only sensible instrument of development cooperation is grants. *They* create no debt.

7 See http://vienna-initiative.com/

8 In 2011, Josef Ackermann, then-CEO of the Deutsche Bank, publicly assured German Finance Minister Wolfgang Schäuble, who was struggling to keep the EU together, that German banks would maintain their levels of engagement with Greece. Despite that, the banks nearly halved their exposure to Greece directly thereafter. For the differences between Greece and Eastern Europe, see Financial Times Deutschland (2011).

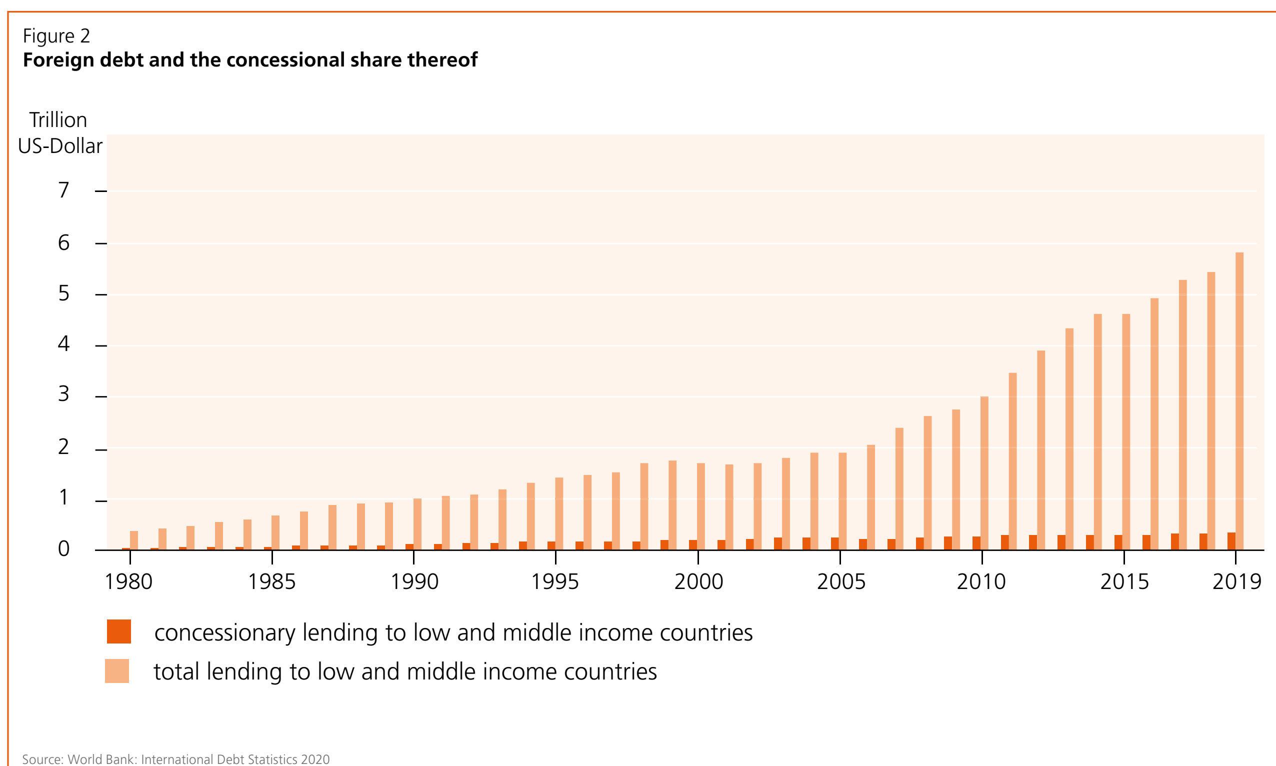
On the creditor side, following painful write-offs under the HIPC Initiative, some countries stopped providing soft loans (at below-market interest rates) – at least to the poorest countries. One such country was Germany, which had remained adamant about the superiority of soft loans over grants as an instrument of development finance longer than other countries. As mentioned, traditional ODA recipient countries gained access to private market financing, which reduced the proportion of ODA in their total debt, making their total debt portfolios more expensive.

For a long time, low interest rates on international capital markets and low initial debt levels – thanks to HIPC and MDRI – obscured the consequences of this trend. However, the economic slump triggered by the COVID-19 pandemic suddenly revealed that some debtor countries no longer have comparatively conciliatory development aid donors who can be expected to accept moratoria, payment extensions or debt conversions. Instead, they have to deal with export risk insurers, who have much more limited room for concessions – or with private investors.

EXPANDING THE GROUP OF STATES WITH ACCESS TO THE CAPITAL MARKET

Before joining the HIPC/MDRI initiatives, poorer countries had very limited access to foreign private financing. By 2019, of the 36 countries that were successfully relieved of their debt burdens under HIPC/MDRI, 23 had received loans from private banks. More importantly, 12 developing countries also gained access to the Eurobond market, which allows them to sell USD-denominated bonds on the European, East

Figure 2
Foreign debt and the concessional share thereof



Source: World Bank: International Debt Statistics 2020

Asian and American markets (World Bank 2020). This has led to a generally welcome broadening of the credit base for distressed countries – but implies hefty increases in the annual cost of capital and more complicated debt rescheduling proceedings.

BLURRING THE LINE BETWEEN MULTILATERAL AND BILATERAL CLAIMS

In early 2019, the Bretton Woods institutions introduced a new term to the international lender landscape: the »transnational lending institution«. These are lenders who – at least according to the World Bank and the IMF – cannot clearly be defined as either »multilateral« or »bilateral«. These include institutes like the South American development bank Banco del Sur founded by Latin American countries to counterbalance the US-dominated Inter-American Development Bank (IDB). Governments in the Persian Gulf also tried to multilateralize their traditional clearly bilateral development banks in order to claim the status of multilateral organizations – not least with regard to any eventual debt restructuring. Needless to say, the Bretton Woods institutions are critical of such efforts. Although they cannot deny the »multilateral« nature of institutions supported by more than two states or public institutions, in fact, these are often dominated by a single actor.

The World Bank and the IMF did not invent the intermediate category of the transnational lending institution for semantic reasons or for the sake of definitional clarity. A creditor's classification plays a key role in how claims are handled in the event of a debt restructuring. Traditional multilateral donors rely on the *preferred creditor status* of their claims, which are not protected under international law but are protected under customary law: In effect, they have *exempt creditor status*. That is, the claims are excluded from any rescheduling negotiations and continue to be serviced. Although there is no legal basis for the traditional multilateral donors' position (cf. Raffer 2009), it has largely been respected by both debtors and competing creditors – apart from the brief interlude of the HIPC/MDRI Initiatives.

This is why the Washington institutions were concerned to see that clearly bilateral actors like China and the Persian Gulf states were starting to channel their lending through newly founded or converted institutions with somewhat broader ownership bases in order to appear to be engaging multilaterally – which gives them the right to claim that same special status in the event of a crisis. After all, the demands for continued service in a crisis can only be met if enough competing creditors waive enough claims so that the debtor can repay.

CRISIS MANAGEMENT SHORTCOMINGS

These trends coincide with the structural deficits of global debt management during the COVID-19 recession.

THE PUBLIC SECTOR AS CREDITOR AND RULE-MAKER

Procedures for rescheduling debt require generally binding rules based on a democratically legitimized public sector. However, when the public sector acts as one creditor amongst others while *also* serving as a rule-maker, it doesn't just cause conflict in intergovernmental relations: One state's claim against another economic entity can also lead to domestic conflict.

The only possible and efficient legal solution to conflicting roles consists of separating the powers of the executive, representing the creditor's claim, and the judiciary, which rules on it if necessary. Thus far, politicians have failed to develop legal procedures regarding intergovernmental creditor-debtor relations. But this is no reason for the current anarchy to be accepted as a quasi-natural state. After all, sovereign states submit to international jurisprudence in many areas of international law: There is no reason why debtor-creditor relations should be an exception.

Particularly seeing how the COVID-19-influenced global debt crisis is being handled, it is appropriate to analyse the procedures (and results) of debt management that have emerged from the dual role of creditor and rule-maker.

Since Western bilateral creditors in the Paris Club have to restore a debtor's solvency so that a predictable flow of payments can be expected once the debt has been rescheduled, they include a »comparability of treatment« clause in agreements. This clause obliges the debtor to obtain from other bilateral creditors at least an equally favourable treatment as the Club has granted (if there is any). As long as an un-cooperative non-Club creditor has no power to collect claims, the debtor country does not suffer from their existence, even after reaching an agreement with the Club. That can change, however, if the creditor country sells potentially bad debts at a high discount to an aggressive private creditor or vulture fund. The vulture fund need not take international relations into account and can sue in international courts for full payment of the outstanding debt plus interest and fees, thus impairing the debtor's international financial relations.[9]

It should also be noted that the Paris Club strategy of using its comparability of treatment clause to interfere with the debtor's relationship with competing creditors is becoming less effective as the Club changes from being a central to a marginal actor. With the DSSI, the Club painfully learned that Paris is no longer the centre of the debt world. On the contrary, the enforceability of its rules also depends on the quantity of its claims against a debtor. China's claims on all the countries in the Global South are now greater than those of all 22 Paris Club members combined. That reality forced the Paris Club to look on as China only partially implemented the

9 A group of vulture funds led by NML Capital Ltd. successfully used that against Argentina in 2015.

debt moratorium decreed despite clauses to that effect – and although China had co-authored the G20 DSSI.

With respect to the DSSI, in April 2020, the Paris Club Secretariat once again acted as if its »best practices« almost automatically served as the bases for all further debt arrangements. However, in July of that year, it had to accept that it could not force the private sector to be treated comparably. The Common Framework for Debt Treatment beyond the DSSI, adopted by G7 finance ministers and central bank governors on 13 November 2020, mandates private sector participation. However, it has no more means to enforce this now than it did six months earlier, and as of November 2020, it is likely that private creditors will manage to avoid making any real concessions by again playing for time (see below and G20 Finance Ministers and Central Bank Governors 2020).

As we have seen, it is both ethically and politically questionable for the creditor to also be the rule-maker. That dual role leads to suboptimal debt restructuring and produces two additional structural defects that can have lasting consequences for all future lending and debt crisis management.

- In their capacity as rule-makers, creditors who are also parties to the conflict can make their own budgetary problems a criterion for granting, refusing, or the calibration of debt relief. Put differently: they may grant a risky loan in the hope of substantial economic or political gains and refuse to accept losses as soon as the loan becomes non-performing on the grounds that their own budgetary situation does not allow it.

  However, since even a G20 decree cannot wish away insolvencies, finance ministers and central bank governors in their 2020 summit communiqué concede the possibility of debt relief – but only »if domestic rules permit this« (G20 Finance Ministers and Central Bank Governors 2020).[10] In no state governed by the rule of law would an insolvency court accept such an argument by awarding the creditor the bankruptcy assets needed to solve budgetary problems. That would of course stir the protest of competing creditors and reduce the rule of law to an absurdity. However, the extent to which even debtor states accept such reasoning was shown in the communiqué of the G24 – the pressure group of developing and emerging countries in international financial institutions – at the 2020 IMF and World Bank Annual Meetings. It calls on bilateral creditors to participate only if they have the necessary »fiscal leeway« (Ofori-Atta et al. 2020: point 7). Such practices ultimately lead to creditors not being held responsible for the quality of their loans.

- When public multilateral creditors demand an exempt creditor status, it has the same effect. This is most evident in the way that all multilateral creditors are exempted from participating in debt rescheduling.[11] In the past, bilateral creditors have also tried to obtain special status vis-à-vis other debt holders, for example, collateralising claims by pledging export earnings from the financed project. Added to this are the attempts already described to create a grey area between bilateral and multilateral creditors using transnational lending institutions to raise and enforce such special claims. The most important – and fatal – consequence of such a pre-granted or enforced status is that lenders can avoid any market discipline. That opens the door to using criteria other than efficient capital allocation during lending decisions. Politically and socially irresponsible lending is the consequence, because the decision-makers can at most be personally prosecuted for wrong decisions if proven to have acted unlawfully. If, on the other hand, a multilateral institution strives to disburse as many loans as possible in the interests of having an impressive balance sheet and high replenishment rates for concessional loan pots – sometimes creating »white elephants« – the population of the country thus harmed has to service the claim. The history of the World Bank is full of such questionable financing arrangements. A current example is the bank's continued financing and promotion of fossil fuel projects in times of climate sensitivity.[12]

THE PUBLIC SECTOR IS POWERLESS OVER THE PRIVATE

We have seen that public actors in the G20 claim to hold sway over debtor states – which is legally questionable – but only dare *appeal* to and »encourage« competing creditors.[13] One aspect of the DSSI implementation reveals a lot about the balance of power between the public and private sectors, namely the initial demand for private sector involvement in the initiative, like the comparability of treatment the Paris Club seeks in its arrangements with debtor nations.

In April 2020, the G20 appealed to private creditors – mainly banks and funds – to defer payments until the end of the year. The Institute of International Finance (IIF), which speaks for large private investors all over the world, signalled its goodwill and announced that it was developing its own

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10 Literally: »In principle, debt treatments will not be conducted in the form of debt write-off or cancellation. If, in the most difficult cases, debt write-off or cancellation is necessary as a consequence of the IMF-WBG DSA and the participating official creditors' collective assessment, specific consideration will be given to the fact that each participating creditor shall fulfill its domestic approval procedures in a timely manner while keeping other creditors informed of progress.«

11 In a preliminary statement on possibly including laggard Sudan in the HIPC Initiative, the IMF points out that in order to implement debt relief for Sudan – which it is eligible for under the Initiative and has been promised since 1999 – the IMF has to obtain the necessary funds from solvent members, and fulfil other conditions. IMF (2020)

12 Guyana's current case is pertinent here. See Urgewald's (2020) video »Carbon Bomb« at https://urgewald.org. Regarding the problem of lack of accountability, see Rich (2019).

13 The G20 leaders' final declaration of the 20–21 November 2020 summit again »encourages« the private sector to participate in debt relief under the »Common Framework for Debt Treatments beyond the DSSI«. Finance ministers had used more binding terms. See G20 (2020).

concept for a moratorium. On 15 July 2020, the IIF presented its »Progress Update« (IIF 2020), which contains guidelines for private sector participation, technical proposals to facilitate that – and repeats that participation must be voluntary.

The result of the IIF publication is – nil. By November 2020, private creditors had not issued one single deferral. On the contrary, a discourse *legitimising* non-participation has made its way into public reporting about the DSSI. Bankers and fund managers are repeatedly quoted saying that a moratorium could make future borrowing more expensive and therefore is not in the interest of indebted countries. Rating agencies got caught up in this messaging during the early phase of the initiative,[14] and even the finance ministers of potential candidates for moratoria used it to justify rejecting the G20 offer.[15] The spokesperson for public creditors in the Paris Club, who had appealed earlier to the private sector to participate, also adopted that argument in a 25 July 2020 report to the effect that the number of countries using the moratorium had risen from 35 to 41 as a consequence of the Club's wise decision to not require mandatory private sector participation. However, right after the April meeting three months earlier, that very person had expressed indignance to non-governmental organizations about such a stance.

The result is that in order to help poorer states contain the pandemic, public authorities are waiving claims and private creditors are continuing to cash in. What's more, the repayment prospects for private investors are suddenly improving in many countries that were verging on debt crises before the pandemic broke out.

THE FEAR OF A DOWNGRADE

The threat of being downgraded, that is, having a country's ratings lowered by the three major agencies, Fitch Ratings, Moody's and Standard & Poor's Global Ratings, is a central narrative in the discussion about private sector involvement. It should therefore be more closely considered here. First of all, some differentiation is necessary because the term »downgrade« is often confused with much broader terms, especially when discussing the threat of specific payment suspensions.

Private creditor warnings that distressed states are making their own access to future credit more difficult by accepting debt relief are usually very general. But they concern *specific* decisions, which may involve the demand for real debt relief, the use of a moratorium for public creditors like the DSSI, or requests for a moratorium to be extended to private debt. The warnings may also contain various threats, such as one or all agencies will drop their ratings, a moratorium will raise borrowing costs or lead to the country being permanently excluded from the international capital market.

Let's first look at the most extreme case of the »haircut«, the nominal curtailment of a creditor's previous claims which can result in the debtor's permanent exclusion from the capital market. Early studies seemed to confirm the risk of permanent exclusion (Cruces/Trebesch 2013).[16] However, more recent studies conducted over longer time spans show a more differentiated picture, and with respect to the narrow range of public sector bonds, show its almost complete *opposite*: Even investors who accepted taking a financial hit still performed better with public bonds from emerging markets than if they had bought risk-free bonds (Andritzky/Schumacher (2019); Meyer/Reinhardt/Trebesch (2019), esp. Appendixes A23-A26). This explains why there is still an appetite for bonds from emerging markets with bad reputations, like Argentina, which has restructured its debt many times in the last decades.

The rather positive connection between access to the capital market and debt relief is also obvious if one eliminates investors' emotional and personal considerations and accepts it as strictly rational in the sense of the classic *homo oeconomicus*: If all other things are equal, and committed creditors grant relief, the chances that future investors will be repaid do not worsen. On the contrary, they improve, albeit marginally. Since 1996, the HIPC Initiative has impressively demonstrated this positive correlation. Until HIPC was expanded through the MDRI in 2005, low- and lower-middle-income African countries had practically no access to international bond markets. Between 2007 and 2019, however, after as much as 90 per cent of their old debts were cancelled through the dual HIPC/MDRI Initiatives, 11 countries were able to sell bonds – that were often oversubscribed – worth more than USD 42 billion on international bond markets (Raffinot/Ferry/Donnat 2020: Table 1). As for the DSSI, Lang/Mihalyi/Presbitero (2020) have shown that the interest premiums that DSSI beneficiary countries had to pay on their bonds did not increase significantly as a result of their participation – and actually decreased overall.

Finally, another consideration plays a role here: Pakistan's Prime Minister Imran Khan has repeatedly called for debt relief to help fight the pandemic (The Express Tribune Pakistan 2020). Khan insists that there should be no downgrade because insolvency does not result from the debtor's misconduct but is due to a force majeure. Future investors have no reason to fear that funds will be spent frivolously.

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14 Fitch, for example, is ready to turn a blind eye to the fact that in all of 2020, only one country's ratings had been lowered: In August that year, the outlook for just one of 38 countries was downgraded – from positive to stable or from stable to negative. See FitchWire (2020).

15 The Kenyan Wall Street (2020). More generally, the role of unidentified »borrowers« serving as key witnesses is also found in IIF chairman Timothy Adams' letter to the Saudi finance minister from September 22, 2020. See https://www.iif.com/Portals/0/Files/content/Regulatory/IIF%20Letter%20to%20G20%20on%20DSSI%20Sept%202020.pdf.

16 Cruces/Trebesch (2013) follow the »classic« argument that financial markets neither forget nor forgive.

OPPORTUNITIES TO INVOLVE THE PRIVATE SECTOR

Neither empirical findings nor other considerations have convinced private creditors to participate in the DSSI. The G20 have consistently campaigned for their *voluntary* participation. How the private sector's participation in the initiative could be facilitated or even made palatable, such as by offering to buy back debt, has been discussed on various occasions.[17] But it has never led to private creditor involvement.

No mention has been made that the private sector can be *forced* to participate. This can in fact be done in a number of ways.[18]

– The United Kingdom has an »anti-vulture« law that prevents private creditors from enforcing their original claims in full in its courts if the defendant country has received debt relief from the UK under the HIPC Initiative. This provision is particularly effective since more than half of all international loan agreements are entered into under British law. Most of the rest of the international loan agreements are made under New York law. A statutory provision preventing lawsuits by private creditors against states participating in the G20 moratorium would be an elegant way to oblige private participation in the DSSI. States could then – in coordination with the G20 and the Paris Club – simply refuse to make payments to uncooperative private creditors for the duration of the G20 moratorium.[19]

– A UN Security Council resolution based on UNSCR 1483 of 22 May 2003, which »safeguarded« Iraq's oil revenues following the fall of Saddam Hussein, could have the same effect: None of Iraq's creditors could seize Iraqui assets in order to collect its claims – worth more than USD 130 billion – in any UN member state. That not only laid the foundation for Iraq's economic restart after the overthrow of the dictatorship and end of the war, but it also enabled the extensive debt relief agreed at the Paris Club in 2004. No one was allowed to get paid off at the expense of all the other creditors. As the UN Secretary-General says with regard to the COVID-19 pandemic, »We are in this together – and we will get through this, together«. The global community has an overriding interest in poorer countries using their scarce resources to fight the pandemic. Furthermore, all the Security Council veto powers who could prevent such a majority resolution also belong to the G20, and are thus authors of the DSSI.

– Some international legal and debt experts have made a third proposal (Bolton et al. (2020)). They suggest creating a Central Credit Facility (CCF) to which each of the debtor countries would pay their debt as contractually agreed rather than to the actual creditor. The G20 will back this diversion of funds by declaring the coronavirus pandemic a global emergency, which it certainly is. This means that legal remedies cannot be lodged against states who use funds that were intended to service debts to fight the pandemic. The CCF would invest the participating countries' stayed interest payments into domestically fighting the global health emergency and debtor countries would formally request their creditors to acknowledge the arrangement. Since the CCF would have the same international legal status as the World Bank and the IMF, it would be similarly immune to legal remedies and could use its own judgment to propose timely and appropriate payments to private creditors at what it considers to be the right moment.

– The African Development Bank (AfDB) has already implemented a fourth, albeit less binding option: In 2008, the African Legal Support Facility was created to help countries on the continent fight off vulture funds by providing legal advice and technical assistance.[20] Not many attacks have occurred since then. This model could be attractive to the G20, which in connection with the DSSI, wants to prevent private creditors receiving preferential treatment at public creditors' expense, but shies away from creating statutory regulations.[21] The threat of supporting defaulting debtor nations before the respective domestic courts could create a sufficiently credible threat to deter creditors from taking legal action – for example, by funding legal assistance, introducing third-party »friends of the court« interventions, by offering information about the actual or legal situation, or by changing relevant laws.

These are just some of the instruments that the G20 or the Paris Club could have used to force the private sector to help fight the pandemic. Instead, they wasted these opportunities by accepting the creditors' narrative that participation must be voluntary because otherwise the future cost of borrowing for the countries involved would more than offset any debt relief. There is, however, no robust evidence to support this claim.

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17 This means using multilateral funds to buy hard-to-collect private sector debt at a discount. To round off the HIPC Initiative, the World Bank has successfully applied this model with the Debt Reduction Facility – but only in a few cases and on the basis of previously agreed debt reductions. Nothing similar is found in the DSSI. That is why such a model would be less suitable for relief like that foreseen in the DSSI moratorium.

18 The opportunities and limitations of collective action clauses (CACs), which since 2003 have been the instrument of choice for the G8, the G20, the Paris Club, the IMF and the World Bank, will not be discussed here. CACs must be included in loan agreements. They are not considered as reactions in individual responses to a crisis – for example, in reaction to the debt crisis triggered by the COVID-19 pandemic. See Kaiser (2016) for a brief assessment of the opportunities and limitations of CACs.

19 The Jubilee USA Network also attempted to change laws of the State of New York during two consecutive legislatures. Despite bipartisan support, it was not possible to get the law passed.

20 More information is found at https://www.aflsf.org/who-we-are.

21 In this case, »statutory« means all types of regulations that do not arise from contracts between parties, particularly those that concern international law.

By appearing to cooperate with the G20, the IIF suggested that a few private investors would surely agree to payment delays because of their overall responsibility. Not a single one has. And that's no surprise. After all, any fund manager who voluntarily waives claims – which most investor protection laws prohibit – while the managers of competing funds do not, would not be a philanthropist but rather a fool. Whoever feels the need to use their wealth to do good can create an endowment or make a donation and get tax breaks. That way they can choose a specific institution for their charity. It would be more than naive for a wealthy lender to waive claims in the expectation that their money will eventually do good through the state budget, over which the private creditor has zero influence, unlike the IMF and also, indirectly, creditor governments. That's why it has hardly ever happened.[22]

It's not the private creditors who have failed in this matter: They've found a clever way to signal their good will without making the slightest contribution to restoring their debtors' fiscal viability. In fact, it's the governments of the G20 and Paris Club countries who have failed. They should have foreseen this manipulation and used one of the ways described above – or something else – to compel private creditors to participate.

THE LIMITATIONS OF THE G20

During the global financial crisis of 2008, the G20 replaced the traditional club of the G8 industrialized countries as the central forum for making rules for the global financial architecture. To many civil society observers, the G20's greater role seemed to have two undeniable advantages:

- Having a larger circle of governments representing majorities of both the world population and its economic output would give its decisions greater legitimacy and clout.
- Including governments from the Global South in making the rules was a first step to changing post-colonial hierarchies.

However, it quickly became obvious that this expansion was associated with a significant diminution in the G20's capacity to act. During the 2008/2009 crisis, it was still possible for the first G20 summit of heads of state and government to massively expand global liquidity. But there have been hardly any courageous and ground-breaking decisions since then, witness the G20's insignificant decisions regarding the current global debt crisis. The G8 was a circle of countries with similar interests whose coordination group tackled a common threat – for example, the uncontrollable debt crisis in the Global South of the late 1990s, which required multilateral debt relief. The G20 is far from that.

Most of the emerging economies do not see this group as a mechanism for jointly shaping globalization – or at most, in exceptional cases. Instead, they view it as a global forum for defending their own interests against Western hegemony. Nothing resembling the HIPC Initiative, in which compelling arguments by a few progressive members – notably (from the mid-1990s) the UK and (from the end-1990s) Germany – were able to convince a group that sought consensus, can be expected from the G20.

One illustration of this shortcoming was the G20 virtual summit of finance ministers and central bankers held on 13 November 2020. There, China's interest in including Western dominated development banks in debt relief clashed with the West's interest in expanding the DSSI to *all* countries in need of relief. The two sides could have broadened the initiative and made it much more effective by accommodating each other's agenda. Instead, the agreements reflect the smallest common denominator and both proposals were shelved.

What does this mean for the (sovereign) debt crisis that will continue to unfold in the coming months?

First of all, no sufficiently ambitious debt relief initiatives like HIPC will »just appear«. Indebted countries will have to defend their interests more vehemently and confrontationally. Individual cases of unilateral suspension of payments must not be avoided in the interest of a creditor's good will. All payment suspensions deserve support from civil society in the North and in the South – as a matter of principle.

Global reforms should continue to be discussed in both the IMF and at the United Nations. Like the resolution that developing countries and China (the G77) introduced in 2014/2015 to create a legally binding debt relief procedure (see Kaiser 2014), reforms will continue to be thwarted by creditor countries. Nonetheless, they are important to keep the global public debate going.

RECOMMENDATIONS FOR A NEW DEBT RELIEF AGENDA

During the world's two simultaneous crises, the COVID-19 pandemic and climate change, the most promising collective initiatives seem to be coming from groups of particularly vulnerable states. Good examples of such group-based approaches to finding answers to the threat of climate change, including through debt relief, are the statements by African Union finance ministers and the joint positioning of small island developing states in the AOSIS (Alliance of Small Island States) network. Such collective approaches could develop into larger coalitions with progressive governments in the North, international organizations and global civil society.

Three specific requirements should apply to future debt relief procedures:

22 Except for »Debt for Development Swaps« in which private creditors really *do* waive payments. However, these are different because with them, creditors have real influence regarding the use of the released funds and receive intangible benefits in return.

- **Governments should not be creditors and rule-makers.** At first glance this seems impossible because governments' ability to lend each other money is an important element of international economic policy and should definitely not be challenged. Furthermore, only elected governments can define the rules governing creditors and debtors. However, this contradiction can be resolved through a more pronounced separation of powers. Just as the judiciary, legislative and executive branches control each other, under international law it is possible to define a legal framework for debtor-creditor relations. That could prevent creditors' political and economic interests from undermining – on an ad hoc and case-by-case basis – sensible debt arrangements that are in the public's long-term interest. Since the 1986 UNCTAD Trade and Development Report, many proposals have been made for juridification to create an orderly procedure for state insolvencies (Kaiser 2013b; UNCTAD 2015).

- **Make it possible to assess the legitimacy of claims in debt relief proceedings.** Currently, decisions regarding the payment or non-payment of a debt are solely based on debt sustainability. Without a doubt, this is the most important and decisive criterion for debt restructuring. But currently no consideration is given to whether the individual creditor's claim is *justified*. Apart from obvious cases like forged documents and blatant corruption, claim verifications have assumed that any signature on the dotted line on each document represents a legitimate claim. This is mainly because creditors have no interest in challenging the claims of competitors for fear that the latter will point to their own shady political, legal or ethical dealings in the same or a different case. In a real-life example, this leads to an externally financed nuclear power plant built on a crevice being treated as a claim that is just as legitimate as successful ODA-funded education projects.[23]

- **Debt relief should go to those in need.** The Debt Service Suspension Initiative has shown that G20 efforts to make unavoidable debt relief as cheap as possible are producing undesirable results: Countries that don't need relief are offered it while countries that *urgently* need it, are *not*. Group restrictions only make sense when they give positive access to debt relief to countries in specific crisis situations that other countries do not need (see above). All countries in crises should be able to use a reformed and legal debt relief procedure. The fear that such an offer would lead to »nobody paying their debts« is unfounded: Like domestic insolvency proceedings, such a mechanism would not be painless or free of charge, and only governments faced with impending insolvency would choose it.

23 For an overview of the various approaches to defining illegitimate debt and some real-life examples, see the edited volume »Illegitimate Debt« published in 2003 by the Illegitimate Debt Working Group at erlassjahr.de.

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ABOUT THE AUTHOR

Jürgen Kaiser co-ordinator of the German Jubilee debt network (erlassjahr.de)

Translated by Nancy du Plessis

IMPRINT

Friedrich-Ebert-Stiftung | Global Policy and Development
Hiroshimastr. 28 | 10785 Berlin | Germany

Responsible:
Elisabeth Bollrich | Coordinator Dialogue on Globalization

Phone: +49-30-269-35-7514 | Fax: +49-30-269-35-9246
www.fes.de/GPol

To order publications:
Christiane.Heun@fes.de

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This publication is part of of the working line »Global economy«, coordinator: Elisabeth Bollrich, elisabeth.bollrich@fes.de.

The views expressed in this publication are not necessarily those of the Friedrich-Ebert-Stiftung. This publication is printed on paper from sustainable forestry.

ISBN 978-3-96250-865-4

SOVEREIGN DEBT RELIEF AS A GLOBAL POWER ISSUE

A Political Economy Analysis

The global recession triggered by the Covid-19 pandemic has hit a big number of countries in the global south very hard. Sovereigns which heavily depended on external borrowing before the crisis were brought to the brink of default. In order to defuse the crisis of the poorest countries, the G20 have offered them a debt moratorium in April 2020. In 2021 this may be turned into real debt relief, if necessary. Still, the initiative suffers from all those structural deficits, which had already prevented timely and sustainable relief before.

Particularly the DSSI does not overcome the power imbalance between debtors and creditors, but rather serves to deepen it. This prevents the implementation of debt relief, if necessary, against the will of powerful players, notably private investors, multilateral banks and non-cooperating sovereigns. Moreover, middle income countries with a huge need for relief have been excluded from the initiative.

The experiences of 2020 give little hope that the G20 will reach a broader consensus for the necessary debt relief, like the G8 did towards the HIPC/MDRI initiatives in 1996-2005. The huge clashes of interests and a lack of give-and-take mentality in the group will prevent it.

Further information on the topic can be found here:
www.fes.de/themenportal-die-welt-gerecht-gestalten/weltwirtschaft-und-unternehmensverantwortung

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