



Alternatives to debtors prison:

Developing a framework for international insolvency

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This report is intended to contribute to the debate about debt and insolvency in relation to international development and does not necessarily represent the views of ACFID.

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Jubilee Australia is an independent non-profit research and advocacy organisation established in 2001, in response to the success of the international Jubilee 2000 campaign for debt cancellation and the need for continued work in this area. Today Jubilee’s work exposes and challenges the policies of government and practices of business that hinder the alleviation of long term poverty, particularly in the Asia Pacific.
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INTRODUCTION

‘Countries never go bankrupt.’

Walter Wriston, Citicorp Chairperson

*‘We still have something like debtors’ prisons
for highly indebted poor countries.’*

Ross Buckley

A business is insolvent when it can’t pay off its debts. So what is international insolvency? How do countries go broke? Why does it keep happening? Who should bear the cost?

The sovereign debt crises in Greece, Spain and Ireland have emphasised the urgency of the issue, but the phenomenon of countries repeatedly going broke (i.e. unable to meet their financial obligations) has a long history. This paper aims to answer the questions above by examining this history and the key patterns that have emerged.

The paper begins in **Chapter 1 – Sovereign Debt Crises** with a summary of the last three decades of global financial problems, first discussing the developing-world debt crisis, followed by the more recent financial and sovereign debt crises in Asia, Latin America and Europe.

Chapter 2 – The Existing Framework for Sovereign Debt Management analyses the dominant perspective on resolving sovereign debt payment. It argues that creditor governments and international institutions interpret the problem as one of economic inefficiency and of imprudent borrowing. The section then canvasses the key actors in the existing framework, with particular emphasis on the role of the Bretton Woods Institutions, the International Monetary Fund and the World Bank.

Chapter 3 – The Case for a New Approach argues for a system of international insolvency to solve shortcomings of the current system. Current mechanisms for resolving debt cause unacceptable suffering for people in indebted countries, do not address the moral hazards of lending, and privilege the role of the Bretton Woods Institutions despite their history of poor policy advice and financial mismanagement.

Chapter 4 – An International Arbitration Mechanism outlines a proposal to introduce insolvency into the international financial system. This approach reduces risk, fosters efficiency, and ensures maximum return to creditors, while protecting the basic rights of debtors. The section ends with a discussion of the broader implications and challenges to implementing this new approach to resolving debt.

This policy paper was inspired by ‘The Bankruptcy of Nations: An Idea Whose Time Has Come’, an article by Professor Ross Buckley in the Fall 2009 edition of *The International Lawyer*.

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CHAPTER 1:

Sovereign Debt Crises

One major cause of sovereign debt crisis is a persistent imbalance on a country's balance of payments, meaning that its income from export and public borrowings is consistently less than its expenses from imports and debt repayments. In the case of the 'Third World' debt crisis that first hit developing countries in the 1980s, countries that had borrowed heavily fell into trouble because of two precipitating circumstances: 1) rising international interest rates (as a result of decisions taken by the US Federal Reserve largely for domestic political reasons); and 2) declining terms of trade – either a rise in cost of imports (e.g. oil price rise) or declining value of exports (particularly the decrease in return from primary commodities). These two changes made it more difficult for countries to meet their debt obligations, and a crisis resulted.

Financial globalisation has increased the incidence of international financial crises, often sparked when foreign or overseas suppliers of capital (usually as bank loans or portfolio investment) suddenly withdraw their capital from a country's financial markets. Financial crises are typically associated with a crisis of currency (the local currency comes under attack and must be devalued), thereby further worsening the predicament. As the descriptions below make clear, international financial crises are a second, increasingly common, cause of sovereign debt crises.

Sovereign debt problems and crises occur outside of the developing world as well. Ross Buckley has shown¹ how sovereign debtors defaulted on debts in the overwhelming majority of cases from the sixteenth to the mid-twentieth century. For example, the Spanish debt crisis lasting almost the entire sixteenth century was caused by the King's heavy borrowing to finance wars against Italy, France and Holland, when bullion and treasure from his overseas empire ran low. Two centuries later, the French faced a similar pattern of defaults on loans from Swiss and Dutch bankers to finance repeated and costly wars with England. During the Great Depression, both the UK and France defaulted on their debts.

Like Europe, debt payment problems in Latin America span centuries. During the nineteenth century, for example, most countries in the region (though not Brazil) engaged in large bond issuances in London. By 1828 all were in default, and a series of recurring debt crises swept the continent in the ensuing decades. In the twentieth century, Latin America was also hit by the Great Depression: by the mid-1930s the vast majority of Latin American bonds were in default.²

1.1. The 'Third World' Debt Crisis

Sovereign debt repayment problems gained unprecedented prominence with the onset of the debt crisis across the 'Third World' in the 1980s. The three-decade long crisis is recounted in greater detail below.

The 1980s Debt Crisis: Latin America

The origins of the 1980s debt crisis can be traced to the program of international development and the related institutions and systems that grew to implement this development in the 1950s and 1960s. The first development loans were given by government export credit agencies and international institutions like the World Bank to ostensibly generate growth and exports in the recipient countries, which in turn, would facilitate repayment. Profligate private bank lending to developing countries in the 1970s was the proximate cause of the crisis for the large Latin American countries. The bank lending was largely a function of excess liquidity in the global financial system, itself due to the Euromarkets boom and the end of the fixed currency regimes, although later injections from so-called petrodollars³ also played a limited role after 1973⁴. Private bank lending was also large in parts of South East Asia (South Korea, Philippines and Indonesia) but was less of a factor in South Asia, sub-Saharan Africa and some of the smaller Latin American states. (See section 3.2 for more analysis of the 1980s debt crisis)

By the end of the 1970s, a number of Latin American countries were using new bank loans to recycle their debts, oftentimes with the new loans on harsher terms. When interest rates rose in 1979 and terms of trade turned against developing countries (especially in primary commodities), the interest on the loans soon became unserviceable.

Mexico and Brazil were the first to default in 1982, followed by other countries across Latin America. Although many

1 Ross P. Buckley, 'Why Are Developing Nations So Slow to Play the Default Card in Renegotiating Their Sovereign Indebtedness?', *The Chicago Journal of International Law*, Vol. 6(1), 2005, pp. 345-361.

2 Carlos Marichal, *A Century of Debt Crises in Latin America: From Independence to the Great Depression, 1820 – 1930, 1989*, Princeton University Press, Princeton, pp. 95, 96, 99, 120, 149–50 (cited in note 5); Darrell Delamaide, *Debt Shock: The Full Story of the World Credit Crisis, 1984*, Doubleday, New York, pp. 53–54; and Marilyn E. Skiles, 'Latin American International Loan Defaults in the 1930s: Lessons for the 1980s?', Research Paper No. 8812, Federal Reserve Bank of New York, April 1988, pp. 1, 15.

3 Analysis from several experts vindicates the conclusion that the role of the oil price hike and the petrodollar phenomenon were not primary causes of the 1970s overlending. The first boom in lending preceded the oil price hike at the end of 1973 and from then on there was an increasing trend of lending that did not correlate with either the 1973 or the 1978/9 OPEC price rises. See Cheryl Payer, *Lent and Lost: Foreign Credit and Third World Development, 1991*, Zed Books, London and New Jersey, pp. 60-63; and Stuart Corbridge, *Debt and Development*, Blackwell, Oxford, 1993, pp. 29-30.

4 Apart from the new excess liquidity, other factors also drove the entry of private banks into the lending bonanza: the growth of multinational firms overseas; changes of governments in the late 1960s and early 1970s from more protective regimes to those more open to foreign investments; a culture of impunity and devaluation of the importance of risk-analysis; and bullish overconfidence in the current commodities boom. Furthermore, reckless bank lending to Latin America and Africa was encouraged by US and European governments to create for themselves new export markets that would make getting through the first oil shock easier. See section 3.3 below.

countries were affected, the majority of the debt was held by the larger economies of Argentina, Brazil, Mexico, and Venezuela.⁵ Initially, the IMF stepped into the role of negotiator and brokered solutions with the banks, other creditors and the debtors that contained a number of conditions. Principal was rescheduled, but interest payments had to be honoured (often with the help of new loans). Banks, in turn, were pressured by governments to not default or pull their money out of the countries in question, while compliance with IMF conditions was required for all debtors.

In 1985, as the crisis spread to more countries, the World Bank introduced the Baker Plan to encourage more credit so that struggling countries could meet their loan repayment shortfalls. When this failed to fix the problem, Treasury Secretary Brady announced a plan in 1989 that offered some write-offs by the banks in exchange for market liberalisations, and in many cases new money from commercial banks to help the countries buy back their debts.⁶ The Brady plan was temporarily successful in stopping the defaults, but problems returned later in the 1990s.

The main outcome of all these initiatives, however, was not to reduce the total debt stock of 'Third World' countries (it was actually 100% higher in 1990 than 1982), but rather to decrease the exposure of private banks to these regions and to increase the exposure of official creditors (from 38.2% in 1982 to 51.3% in 1990).⁷ Moreover, these initiatives were mainly focused on Latin American and middle income countries while a different sort of debt crisis was worsening in Africa.

The Debt Crisis in Africa

The debt crisis manifested differently in Africa than it did in Latin America and parts of Asia. First, the African debt crisis hit later. Although by the late 1970s the total sub-Saharan debt was 25% of GDP, problems did not arrive until 1984/5, when the debt to GDP ratio reached 60%. The cause of African indebtedness was a combination of declining terms of trade and the increasing cost of oil (many states were non-oil producers). Most of the debt was not to commercial lenders, but to official and multilateral creditors like the World Bank and the IMF, who were also able to access much of the new liquidity (including petrodollars) and recycle it to poorer states struggling to cover their balance of payments deficits. Although absolute debt loads were smaller in quantity, the general economic stagnation on the continent greatly exacerbated the impact of indebtedness. At the same time, austerity measures forced on African nations from the mid-1980s onwards—allegedly to reduce indebtedness and cure underdevelopment—only contributed to the problem. Thus by 1993, the debt-to-GDP ratio for sub-Saharan Africa had reached 80%.⁸

The debt crisis in sub-Saharan Africa and other highly impoverished countries continued throughout the 1990s.⁹ By the middle of the decade there was growing unease at the punitive costs of debt repayments for many of the poorest indebted countries, most of which were African. Powerful civil society campaigns, spearheaded by the global Jubilee 2000 movement, forced G8 leaders and the IMF and World Bank to introduce a debt relief structure for the countries hardest hit by these repayments. The resulting Heavily Indebted Poor Country Initiatives (HIPC I in 1996, HIPC II in 1999) sanctioned conditional debt relief for two or three dozen of the world's poorest countries. However, these interim solutions were not enough, and with further public pressure, in 2005 an agreement was reached on the outright cancellation of an additional 40 billion USD owed to the IMF, World Bank and some of the regional development banks.¹⁰

⁵ Importantly, the majority of the debts by monetary value were contracted by countries that were ruled by authoritarian (or semi-authoritarian) regimes and Cold War allies of the US. This political context was not irrelevant to the process by which indebtedness developed.

⁶ See Payer, *Lent and Lost*, op. cit., pp. 90-101 and Corbridge, *Debt and Development*, op. cit. pp. 63-85 for slightly different descriptions of, and perspectives on, these various plans.

⁷ Corbridge, *Debt and Development*, op. cit., p. 82.

⁸ Ngaire Woods, *The Globalizers: The IMF, the World Bank, and Their Borrowers*, 2006, Cornell University Press, Ithaca and London, pp. 146-148.

⁹ Some of the larger middle income countries of Latin America and Asia's substantial debt repayments were justified on the basis that their economies were growing, despite millions within their population remaining impoverished.

¹⁰ This was called the MDRI (Multilateral Debt Relief Initiative). Importantly, both HIPC and the MDRI required countries to implement sets of economic and policy conditions laid down by the IFIs.

1.2. Financial Crises of Recent Decades

The last decade and a half has seen an increasing number of financial crises hit emerging economies in the Global South and more recently even developed economies in the Global North.

The Asian Financial Crisis and Argentina

The first spate of recent crises broke out in the late 1990s in East Asia, eventually spreading to other economies such as Russia and Argentina. What were the causes of the 1997/8 Asian Financial Crisis?

With increasing financialisation of the global economy through the 1980s and 1990s, many emerging economies were encouraged to begin opening up their markets to foreign capital. However, these countries often possessed immature financial systems characterised by a lack of regulation and worldly knowledge about making prudent loans. The combination of naïve banking systems and the removal of barriers to international capital was a recipe for disaster. The Asian Financial Crisis started with an attack on the Thai Baht in 1997, triggering a region-wide panic.¹¹ The crisis spread as financiers and traders with money invested in Thailand feared rolling over their loans and investments in neighbouring Malaysia, Indonesia and South Korea.

As international capital pulled out, many of the local banks had difficulty meeting their international debt obligations. Whole banking systems collapsed as countries tried, ultimately unsuccessfully, to defend plummeting currencies. With government resources stretched to defend their exchange rates (all were forced to take out large international loans), the collapse of various financial systems ricocheted throughout the economies and high interest rates and a lack of access to credit sent many businesses broke. In all three countries, recession and unemployment followed.

Indonesia was hit hardest and their immature banking system completely collapsed. The government stepped in to secure the banking system and assumed the debts to foreign banks that had been lending money to their Indonesian counterparts. With the government unable to meet these debts, an emergency financing package organised by the IMF allowed the government to pay off these foreign creditors. South Korea and Thailand were both hugely affected, but recovered much more quickly than Indonesia. Further analysis of this crisis is provided in Chapter 3.

Problems in Argentina

The effects of the Asian Financial Crisis spread far and wide, most notably to Russia, and with devastating repercussions in Argentina. Argentina was particularly vulnerable because in pegging its peso to the dollar throughout the 1990s, the currency became massively overvalued and made the country's exports less competitive. Also, large-scale financial liberalisation meant that Argentina had been able to borrow large amounts from abroad, thereby financing its deficits with borrowed money. The situation could only last so long: the influx of capital dried up after the Asian Financial Crisis, the economy entered a downturn, and the country's indebtedness rose steadily from 1998-2001. By 2001, the country had entered a deep recession, worsened by government austerity measures. The impact on Argentinians was severe: the middle class was decimated and half the population fell below the poverty line. In January 2002, Argentina officially defaulted on its debts.

The long-term plan of the Kirchner government was to reduce its debt-to-GDP ratio by: 1) untying the peso from the dollar to make its products more competitive (especially relative to trade competitors like Brazil and Russia); and 2) renegotiating debts. In March 2002, the country abandoned its fixed currency regime. This brought further suffering as food prices rose. However, by April the worst of the crisis was over and devaluation kick-started a gradual recovery.¹² Aggressive negotiations with its creditors in 2005 resulted in a 76% cut on claims.¹³ Though there have been some holdouts, most creditors have, in the end, accepted these terms.

¹¹ For some of the deeper causes of the crisis, Ross Buckley argues the following: '[The] crisis was the result of a number of factors including (i) fixed exchange rates, tied to an appreciating U.S. dollar when the currency of the countries' principal competitor, Japan, was depreciating; (ii) weaknesses in the local financial sectors and their prudential regulation so that local banks were able to borrow heavily abroad and re-lend the proceeds domestically without hedging the foreign exchange risks (i.e. relying utterly on the peg of the local currency to the Dollar to hold); (iii) crony capitalism which further eroded the effectiveness of prudential regulation; (iv) excessive capital inflows facilitated by premature liberalisation of local financial sectors; and (v) a region-wide loss of confidence.' See Ross P. Buckley, 'The Bankruptcy of Nations: Let the Law Reflect Reality', University of New South Wales Faculty of Law Research Series Working Paper 20, June 2009, p. 8, available online: <http://law.bepress.com/unswrps/fllrps09/art20>.

¹² Buckley, 'The Bankruptcy of Nations: Let the Law Reflect Reality', op. cit., p. 11; and Costas Lapavistas et al, 'The Eurozone Between Austerity and Default', Research on Money and Finance, RMF Occasional Report, September 2010, pp. 57-9, available online: <http://www.researchonmoneyandfinance.org/2010/09/new-rmf-report-eurozone-between-austerity-and-default/>.

¹³ For a good summary of the Argentine government's strategy with respect to its creditors, see Anna Gelpern, 'What Iraq and Argentina Might Learn from Each Other', The Chicago Journal of International Law, Vol. 6(1), 2005, pp. 402-410.

The Eurozone in Crisis Part I – Iceland and Ireland

Recent years have seen financial disaster penetrate the borders of Europe with a series of debt crises reaching Ireland, Iceland, Greece, Spain and Portugal. First to face trouble were Ireland and Iceland. After fashioning its economy as a dynamic new financial centre, Iceland ran into problems when it emerged that two of its major banks, Landbanki and Kaupthing, had made risky overseas loans. In October 2008, these two banks were forced into receivership. After initial resistance, the Icelandic government bowed to international pressure to pay back the banks' foreign depositors, who were mainly small savers in Britain and the Netherlands. To cover these obligations, Iceland borrowed 3.9 billion Euro from the UK and the Netherlands and accepted a 1.7 billion Euro IMF bailout package. The Icelandic government has twice since rejected the harsh repayment terms requested by its creditors, once in August 2009 and again in April 2011.¹⁴

Ireland's troubles go back to the early 2000s, when some of its major banks fueled a real estate boom with extremely lax borrowing requirements. Rather than rely on the domestic savings of Irish householders, the banks borrowed money overseas in order to transfer huge sums to the construction sector, which was at its peak and responsible for a quarter of the country's GDP. As the real estate market began to contract and the global financial crisis set in 2007/8, it became clear that the banks were massively overexposed to the tune of tens of billions of Euros. In late September 2008, faced with the decision to either guarantee the bank debt or cut its banks loose, the Irish government chose the former, effectively taking on an 80 billion Euro debt to mainly foreign bondholders. Ireland immediately implemented austerity measures, but the economy was by then on a one-way spiral downwards. Two years later, the Irish government was forced to accept a 85 billion Euro rescue package from the European Central Bank and the IMF. Ireland's unemployment currently hovers at 14-15% and the country has a huge population outflow as both native Irish and recent immigrants have been forced to seek opportunities elsewhere.¹⁵

The Eurozone in Crisis Part II – Greece, Spain and Portugal

The situation currently emerging for the Mediterranean economies of Spain, Greece and Portugal is different from Ireland and Iceland. Unregulated financial sectors are a factor, but not the main cause of the problems. The underlying drivers in these states have been payment imbalances that have emerged within the Eurozone since the adoption of the Euro. Germany has run consistent trade surpluses partly because its undervalued currency makes its exports highly competitive, while peripheral countries like Spain, Greece and Portugal have run payment deficits. As a result, they have borrowed funds from overseas to make up for these recurring shortfalls.

Although the popular perception is that government overborrowing caused the problems in these countries, the truth is much more complicated. Most of this debt has been incurred not by the governments, but by Greek, Spanish and Portuguese banks, businesses, and households, either to fuel real estate booms (Spain) or to enable consumption or business investment that savings would have allowed in the past. Government overborrowing was most significant in Greece (at 42% of total debt); the rest is held by banks, businesses and households in roughly equal proportions. The statistics for Spain and Portugal are show the proportion of government debt to total debt is a mere 13% and 15%, respectively.¹⁶ Borrowing was enabled by a reduction in financial barriers in these countries and a tendency by the financial markets to misprice the risks of associated bonds (any Eurozone country was deemed inherently safe, which meant that risks were consequently downplayed).¹⁷

What is more important, lending by European banks and financial institutions did not come to a halt when the global financial problems arose in 2007. Rather, lending increased as central banks pushed up liquidity to help jump-start the system when the credit crunch hit. As a result, banks from core Eurozone countries (mainly France and Germany) used the available liquidity to increase their lending to the public and the private sector in Greece, Spain and Portugal in 2008 and 2009.¹⁸ Revelations that the Greek government had misrepresented the size of its budget deficit in early 2010 was the precipitating factor for an investor panic and for Greece to ask the European Union for assistance. In May 2010, the EU and the IMF offered Greece a 110 billion Euro bailout (80 billion from the EU and 30 billion from the IMF).

¹⁴ European Trade Union Institute, 'Europe needs fair and transparent debt work-out mechanisms: lessons from the Icelandic case', ETUI Policy Brief, European Economic and Employment Policy, Issue 2, 2010, pp. 2-3.

¹⁵ Michael Lewis, 'When Irish Eyes Are Crying', Vanity Fair, March 2011, available online: <http://www.vanityfair.com/business/features/2011/03/michael-lewis-ireland-201103>.

¹⁶ Lapavistas et al, 'The Eurozone Between Austerity and Default', op. cit., pp. 7-8.

¹⁷ Ibid., pp. 11-22.

¹⁸ Ibid., pp. 23-26.

CHAPTER 2:

Existing Framework for Sovereign Debt Management

TWO

2.1. The Dominant Approach

The mainstream approach to managing sovereign debt crises is dominated by two main preoccupations: 1) concern with moral hazard of borrowers; and 2) concern about economic efficiency.

Moral Hazard of the Borrowers

Moral hazard describes the incentive for irresponsible behaviour when, for one reason or another, an actor is insulated from the implications of his or her deeds. The current international framework for debt management is concerned with the moral hazard of borrowing governments. This approach sees the indebted government as responsible for taking out imprudent loans which it cannot repay, and that protections made available to rescue these recalcitrant countries from the consequences of their errant behaviour would only serve to increase moral hazard. On this basis, the creditor community vigorously resisted all calls for debt relief throughout the 1980s as a response to the Latin American and African debt crisis.¹⁹ As Secretary of the US Treasury Donald Regan said in the early 1980s:

I don't think we should just let a nation off the hook because we are sympathetic to the fact that they are having difficulty. As debtors, I think they should be made to pay as much as they can bear without breaking them. You just can't let your heart rule your head in these situations.²⁰

It follows logically from this approach that taxpayers from wealthy countries are 'effectively subsidising the defaulting States'²¹ when an IMF bailout relief is provided.²² This framework also justifies the conditional debt relief offered to poorer countries. The structural amendments or 'conditionalities' required of countries seeking debt relief— either through the Paris and London Clubs, or through HIPC/MDRI – reflect creditors' desire to avoid debtor country moral hazard. It was believed, ostensibly, that only those countries that had implemented a recipe of economic reforms to restructure their economies towards more market-friendly policies had earned the right to benefit from debt cancellation. It was further believed that such reforms would make it more unlikely that countries would get into debt problems in the future. Speaking of the government's participation in the Heavily Indebted Poor Country (HIPC) initiative, Senator Robert Hill firmly expressed Australia's commitment to this dominant approach, declaring 'debt relief without true adjustment would be wasted'. Unconditional cancellation, he said, would further encourage unsustainable debts by rewarding weak economic performance and shielding governments from their responsibilities.²³

Economic Efficiency

The dominant approach to debt management is also concerned with the economic inefficiencies in the current system. The approach oftentimes draws heavily on the principle of domestic bankruptcy legislation in the US and elsewhere.²⁴ Two recurring inefficiencies of concern are: 1) the collective action problem; and 2) the order in which creditors are repaid. Both reflect creditor fears around recouping losses.

One of the most common efficiency concerns relating to debt restructuring is known as the 'holdout problem', wherein a small number of creditors negotiate better payment terms for themselves by resisting a deal.²⁵ This problem has grown in recent years as private debt has increasingly taken the form of bonds instead of commercial bank loans. Those familiar with the irresponsible bank lending of the 1970s, and the bailouts that followed, might see this as a welcome trend because it means that the risks are not concentrated in financial institutions deemed 'too big to fail'. But the re-emergence of bondholders, it is argued, makes it more difficult to reach an agreement because bondholders are more numerous than the banks that lend to overseas states and because bonds are actively traded making it more difficult to keep track of their owners.²⁶ A popular solution to the collective action problem is the use of collective action clauses in bond contracts, whereby bondholders agree in advance to accept a determination of a majority, often 75%, should any variation of the terms of the debt be needed.²⁷

19 See Bresser Pereira, 'Solving the Debt Crisis: Debt Relief and Adjustment', testimony before the House Committee on Banking, Finance and Urban Affairs on the hearing on the "Less Developed Country Debt Crisis", 5 January 1989, 101st Congress, First Session, 330; and Lee C. Buchheit, 'Debt Restructuring-Speak: "¿Senor, que pasa?"', International Financial Law Review, Issue 10, March 1991.

20 As cited in W. J. Quirk, 'Will an Underdeveloped Countries Debtors' Cartel Squeeze the Big Banks?', Business and Society Review, Vol. 47(1), 1983, p. 10.

21 Steven Schwarcz, 'Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach', Cornell Law Review, Vol. 85, 1999, p. 964.

22 In reality IMF emergency loans barely touch the ground in the indebted country, rather going straight to pay back the commercial banks of wealthy countries.

23 'Questions on Notice "Heavily Indebted Countries: Debt Relief"', Australian Senate Hansard, Question 604, 11 February 1999, available online: http://parlinfo.aph.gov.au/parlInfo/genpdf/chamber/hansards/1999-05-11/0175/hansard_frag.pdf;fileType%3Dapplication%2Fpdf.

24 One example is that of Steven Schwarcz, who makes a close reading of domestic bankruptcy law and its applicability in the sovereign context. See Schwarcz, 'Sovereign Debt Restructuring', op. cit., pp. 973-975; and Anna Gelper, 'Building a Better Seating Chart for Sovereign Restructurings', Emory Law Review, Vol. 53, 2004, pp. 1126-1127.

25 This is technically known as a collective action problem, a term which refers to the difficulty of getting creditors to act in concert for a negotiated solution when a single or small number of creditors decide that it in their interests to refuse to agree on a settlement that the majority of creditors (and the debtor) seeks. See Schwarcz, 'Sovereign Debt Restructuring', op. cit., pp. 960-962.

26 Schwarcz, 'Sovereign Debt Restructuring', op. cit., pp. 1004-1005.

27 Although CACs are welcome as far as they go, they do not replace the need for a broader mechanism. CACs can facilitate rescheduling but not relief (unless the debtor officially defaults); moreover, CACs relate only to bonds, which are just one part of the debt problem.

Another efficiency concern is the tendency for creditors to ‘rush to the courtroom’ to seek legal recourse for repayment ahead of other creditors. This is inefficient because, as with the collective action problem, it can pose delays to debt settlement processes that are often not in the long-term interests of the debtor. Historically, there has tended to be a hierarchy among creditors regarding who gets paid first. International Financial Institutions (IFI) tended to be at the top of the list, along with other emergency bridge financiers. This is ostensibly because emergency money means a country is having repayment difficulties, and therefore creditors extending such finance should always be at the top of the list for repayment. As a result, the established repayments order looks like this: emergency bridge financing, the IMF, the World Bank, then trade and interbank lines and bonds. In recent years, the issue of an established repayment order has become more complicated with the increasing market share taken by bondholders, the importance of domestic debt in some restructurings, and some unexpected court decisions²⁸ (see Box 1).

Insofar as the dominant approach to debt management does acknowledge the position and interests of less-developed countries, it tends to focus on the impacts that lasting debt can have on investment and growth, i.e. concerns about the efficiency costs to less-developed country economies. This is known as the ‘debt overhang’ problem, the notion that ‘high levels of debt could lead to inefficiently low levels of growth because the need to repay creditors acted like a tax on investment’.²⁹ This recognition was what led to the institution of the so-called market-based debt reduction programs (debt buy-backs and debt-equity swaps) in the 1980s and 1990s.

28 Some analysts propose a statutory solution to this problem: the suggestion that all debt contracts contain transparent, enforceable priority systems. Anna Gelpern argues that countries should follow the lead of US states like California, and include payment priorities in debt contracts from the outset. Because Gelpern believes that countries could never find an agreed priority structure between them, the best solution is for individual countries to make their own determinations when they take on loans. Such a system, she argues, would make clear from the outset who will get paid and in what order if there are repayment problems later on. See Anna Gelpern, ‘Building a Better Seating Chart for Sovereign Restructurings’, op. cit., pp. 1126-1127.

29 Kenneth Rogoff and Jeromin Zettelmeyer, ‘Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001’, IMF Staff Papers, Vol. 49(3), 2002, p. 476, available online: <http://www.imf.org/External/Pubs/FT/staffp/2002/03/pdf/rogoff.pdf>.

2.2. The Key Actors

The Creditor Clubs

For many years, the most important institution for the management of official international debts was the Paris Club. The Paris Club is an informal grouping of nineteen OECD countries that meet in the French Treasury in Paris, where there is a permanent secretariat. The Paris Club only negotiates bilateral debts, of which there are three sources: those from donor country foreign aid programs, from export credit loans (lending to enable exports from an industrialised to a developing country), or from private bank loans that were officially guaranteed by the government. The Paris Club's position as the most powerful actor in the debt architecture began to recede in the 1980s and 1990s (as explained below).

The Paris Club has historically tended to do only debt restructuring, i.e., agree to postpone the debt payments until the country is in a better position to repay. This is still generally the case for middle-income countries, although the poorest have occasionally had some of their actual debt stock reduced.³⁰

The Paris Club processes include the following features:

- Creditors negotiate as a group, meeting with each individual debtor country separately. (If debtors also owe money to other countries, they are asked to seek comparable terms with them.)
- A key *raison d'être* is to avoid countries from defaulting outright on their debts. As a result, a country is not supposed to ask for a rescheduling unless it is in risk of 'imminent default', which has traditionally meant that it has substantial arrears owing on its overseas debts.
- It relies heavily on and supports the authority of the IMF and requires that debtor countries reach a stabilisation agreement with the IMF before seeking restructuring agreement.

The Paris Club was established in 1956. In its early life, as the creditor group was establishing its *modus operandi*, it met rather infrequently, averaging around one agreement per year. As the developing world debt crisis hit, the frequency of its agreements increased substantially (concluding 56 agreements between 1978-1986, compared to 26 between 1956-1978).³¹ This trend continued and as of 2007 it had signed over 398 agreements with 83 debtor countries.³² Although the Paris Club still meets regularly when it is called to do so, it has declined in importance with the rise of multilateral lending and the increasing predominance of the Bretton Woods Institutions in managing the debt crisis.

The London Club is an informal creditor grouping for commercial banks. It has a shorter history than the Paris Club, having its first meeting in 1976. In many ways it functions similarly to the Paris Club. For example, it too requires debtors to reach an agreement with the IMF. But unlike the Paris Club, its agreements are legally binding.³³ Yet with the decline of the private banking boom in developing countries after the 1970s and the subsequent rise of portfolio finance, the London Club's role has receded to an even greater extent than that of the Paris Club.

Bretton Woods Institutions

The IMF

The International Monetary Fund and the International Bank for Reconstruction and Development (which became the World Bank) were both created in 1944 at a conference in New Hampshire, USA, as the Allies made plans to manage the postwar world economy. The IMF has always had a central role in the management of debt given its initial role to provide emergency financing to countries with balance of payments problems.³⁴

As the global economy evolved through the postwar period, many countries (especially newly de-colonised nations) had to apply to the IMF for help getting their economies through various trade and currency crises. A certain amount of financing could be accessed (a quarter of each member country's financial quota) with no strings attached. If more money was

³⁰ With the HIPC I and HIPC II Initiatives, the Paris Club formally adopted the principle of forgiveness of a portion of its debts for eligible countries. In 2005/6, the Paris Club wrote off 80% of Iraq's debt, although this has been seen as a largely political decision led by the US.

³¹ Alexis Rieffel, 'The Role of the Paris Club in Managing Debt Problems', Essays in International Finance, International Finance Section, Department of Economics, Princeton University, Princeton, No. 161, 1985.

³² Thomas Fritz and Philipp Hersel, Fair and Transparent Arbitration Processes. A new road to resolve debt crises, FDCL-Verlag, Berlin, August 2002, p. 20, available online: <http://fdcl-berlin.de/publikationen/fdcl-veroeffentlichungen/blue-21-misereor-2002-fair-and-transparent-arbitration-processes-a-new-road-to-resolve-debt-crises-schulden/>. For a breakdown of the 398 agreements concluded by the Paris Club to 2007 see Club de Paris, Breakdown by year of agreement already concluded by Paris Club creditors, 2010, available online: <http://www.clubdeparis.org/sections/services/chiffres-cles/81-accords-conclus-par-les>.

³³ See Alexis Rieffel, 'The Role of the Paris Club in Managing Debt Problems', op. cit., for a good discussion on the differences between the Paris Club and the London Club.

³⁴ For some countries, this included those importing more than they were exporting or those attempting to keep their currencies valued at a certain level. See Fred L. Block, *The Origins of International Economic Disorder: A Study of United States Monetary Policy from World War II to the Present*, University of California Press, Berkeley and Los Angeles, 1977, Chapter 3, pp. 32-69; and Cheryl Payer, *The Debt Trap: The International Monetary Fund and the Third World*, Monthly Review Press, New York and London, 1974, Ch. 2, pp. 22-49.

required, conditions would be attached to the loans which were intended to ensure the government's balance of payments improved, such as importing less, exporting more and tightening government spending.

The IMF has enjoyed the confidence of both the creditor governments and the financial markets. Historically, the solutions it prescribed for 'adjustment' were deemed appropriate and beneficial, and the IMF naturally grew into the role as 'financial gatekeeper' of the world economy. The Paris and London Clubs have made debt restructuring conditional on indebted countries first reaching a deal with the IMF given its supposed expertise.

The World Bank

At the moment of its creation and throughout its early years, the World Bank was smaller and less powerful than the IMF. However, its capacity and influence grew, at first steadily, then rapidly, through the ensuing decades.³⁵ Until the 1980s, the Bank had little officially to do with debt management or restructuring, but was focused on providing long-term finance for development projects or assisting the private financial markets in doing so.³⁶ During the 1970s and into the 1980s, the Bank increased its lending to the poorest of the poor, which helped it cement its place at the centre of the system. Nevertheless, the Bank's role in debt management remained unofficial until the 1980s debt crisis. Its greater role in debt management was also facilitated by the development of policy-based lending (itself driven by a move in development economics to increase the role of markets vis-à-vis the state in development), by which the Bank increasingly assumed more of the traditional role of the IMF by actively directing developing country policy. Its role also grew amid the increasingly drawn out debt crises as it was brought in to assist perennially indebted countries. By the late 1980s, it was entrenched with the IMF as dual manager of the debt crises enveloping the developing world.

The Heavily Indebted Poor Countries Initiative

In 1996, G7 leaders directed the World Bank, under President James Wolfensohn, to introduce and manage an official version of ad hoc Paris Club debt relief options for 27 'Heavily Indebted Poor Countries' (HIPC). This first HIPC Initiative, and its successor, the Enhanced HIPC Initiative (or HIPC II) of 1999, followed intense public pressure regarding the impact of the debt crisis on the world's poorest countries. HIPC represented an important departure— for the first time the Bank's role in debt management was formalised and World Bank and IMF debt was included for write-offs. While cancellation of bilateral debts was mostly done through Paris Club agreements, multilateral claims on the poorest countries were 'forgiven' only to the extent needed to return the total debt stock to sustainable levels, with the responsibility for defining 'debt sustainability' thresholds by the creditor institutions themselves, as advised by the IMF.

Even following two amendments of the initiative to provide more flexibility and faster relief, the Debt Sustainability Framework of the World Bank was criticised for not taking into account the resources less-developed countries needed to tackle poverty and reach the internationally agreed Millennium Development Goals by 2015. This resulted in a further concession, the Multilateral Debt Relief Initiative (MDRI), agreed to at the G8 Summit in Gleneagles in 2005. The MDRI authorised complete, rather than partial, cancellation of multilateral debts for HIPC countries that had met specific criteria, including implementation of policy changes similar to the Bank's structural adjustment programs.

³⁵ In its early years Wall Street would exert, if not control, strong influence over the institution and preferred to keep its loan portfolio small so as not to 'compete' with Wall Street, and the Bank lent exclusively to larger developing countries, especially US Cold War allies. However, by the early 1960s, new World Bank institutions were set up to help speed the movement of capital from North to South, including the International Finance Corporation (IFC), mandated specifically to stimulate private sector lending in 1956 and the International Development Association (IDA) in 1960, which was to give soft loans to poorer countries. The expansion of the Bank and its affiliates was further assisted by the expansion of liquidity enabled by the Euromarkets boom, which allowed the Bank to tap into a much larger investment pool, and the twelve year tenure of former US Defence Secretary Robert McNamara.

³⁶ For good histories of the early years of the Bretton Woods Institutions see Block, *The Origins of Economic Disorder*, op. cit., Ch. 2; Ngaire Woods, *The Globalizers*, op. cit., Ch. 1; and Bruce Nissen, 'Building the World Bank' in Steve Weissman (ed), *The Trojan Horse: A Radical Look at Foreign Aid*, Ramparts Press, Palo Alto, California, 1975, pp. 35-60. For the World Bank specifically, see Michael Goldman, *Imperial Nature: The World Bank and Struggles for Social Justice in the Age of Globalization*, Yale University Press, New Haven CT, 2005, Ch. 2.

Box 1: The Rise of the Bondholders

An impact of the increasingly open financial markets in developing countries has been the growth of a major new creditor class, the bondholders. With many more countries now listing government and privately issued bonds on their own or foreign stock exchanges, bondholders have become a powerful new creditor group rivalling private banks and the official creditors like developed country governments and multilateral institutions. Bondholders, often chasing large returns, have become the latest creditor grouping to expose themselves to developing world debt. In many countries, bondholders have replaced private banks as the holders of the majority of private debt (i.e. debt not resulting from country loans, export credits or from international financial institutions).

The implications of this development are both positive and negative. On one hand, countries historically have had more power when repudiating claims to bondholders than to powerful foreign banks or foreign governments. In the case of Argentina, the presence of a large amount of its debt being held by foreign bondholders might have helped its aggressive approach to its creditors in 2001/2. This suggests that developing countries have more options when it comes to negotiating debt settlements. On the other hand, the finance ministries of developing countries are more concerned, now more than ever before, with their credits ratings and the consequences for policy flexibility (and inflexibility) that this implies. Furthermore, it is more complicated to deal with bondholders when it comes to sovereign debt negotiations.

2.3. Minimalist Solutions

The dominant approach proposes either relatively minor adjustments to the current management of sovereign debt crises, or no changes at all. It holds that the problems are not major enough to warrant significant reform. Instead, the argument goes, let the Paris Club and the Bretton Woods Institutions continue to do the job that they have been doing. Parties concerned enough to propose amendments offer ones that are relatively small. These amendments do not change the financial architecture, and the solutions are led by the institutions currently in control.

Creditor institutions have resisted major reform. The one instance when a creditor institution did propose a significant change to the structure of debt management (introduction of the Sovereign Debt Restructuring Mechanism), control was left firmly in the hands of the IMF and official debt (whether from bilateral loans or lending by multilateral development banks and the IMF itself) was off the table.

The Sovereign Debt Restructuring Mechanism (SDRM)

In November 2001, in the middle of the chaos of the Argentine default, the IMF launched a proposal for a Sovereign Debt Restructuring Mechanism (SDRM). The final IMF proposal had four principal elements: 1) majority restructuring to circumvent the collective action problems prevalent with bond financing; 2) a stay on litigation; 3) protection of creditor interests by a restraint on the debtor paying non-priority creditors and by an IMF assurance of good economic conduct by the debtor to give the creditors an assurance the debtor will pursue policies that protect asset values and restore growth; and 4) seniority for new lending, so as to attract it to the country.³⁷ Although the IMF appointed a separate Sovereign Debt Dispute Resolution Forum (SDDRF) to decide disputes between debtors and creditors, in reality, the IMF retained many important powers, such as determining which countries were eligible and the inappropriate level of debt sustainability. Moreover, the Forum was only used for commercial bank debt leaving the IFIs and the Paris Club in control of debt from the official sector.³⁸

³⁷ See Buckley, 'The Bankruptcy of Nations: Let the Law Reflect Reality', op. cit., pp. 32-33, available online: <http://law.bepress.com/unswwwps/flrps09/art20>; and Ross P. Buckley, 'The IMF's Proposal for a Sovereign Debt Restructuring Mechanism: An Australian Assessment', Australian Journal of International Law, 2003, pp. 1-23.

³⁸ See Buckley, 'The Bankruptcy of Nations: Let the Law Reflect Reality', op. cit., pp. 33-34.

The IMF solution is squarely minimalist for two reasons. First, it was motivated by the same efficiency concerns shared by the dominant approach. Collective action problems, order of repayments, and moral hazard of the debtors were the priority concerns of its architects. Second, the SDRM was an attempt to keep debt management 'all in the family',³⁹ since the wealthy nations that control aid disbursement also control the Paris Club, IMF and World Bank. Although the SDRM made debt management more streamlined, it kept debt management under the control of the 'creditors' cartel', the same groups that have traditionally managed global economic governance in the postwar era.⁴⁰

By 2003, the SDRM was shelved for a number of reasons. First, the financial sector was against it, despite the fact that it arguably served their interests well.⁴¹ Secondly, although it is rumoured that the US Treasury Secretary was initially behind the Krueger proposal, by 2003 the US administration had withdrawn support for the idea. By this time, the panic over the Argentine crisis had died down and the global economy was booming again. It is alleged that debtor countries' mistrust of the IMF was also a reason, as some of the more powerful emerging market economies did not want to extend the IMF's financial control over themselves.⁴²

39 The SDRM was, in the words of Lee Buchheit, 'intended to accomplish what the diplomats, gunboat captains, administrators and judges of the last two-hundred years failed to achieve: an effective method by which the official sector could encourage orderly workouts of private sector claims against distressed sovereigns without shouldering the full moral, political and financial responsibility for these workouts'. See Lee C. Buchheit, 'The Role of the Official Sector in Sovereign Debt Workouts', *The Chicago Journal of International Law*, vol. 6(1), 2005, p. 342.

40 See critiques made of the SDRM by Buckley, 'The Bankruptcy of Nations: Let the Law Reflect Reality', op. cit., pp. 33-35; and Jürgen Kaiser, 'Resolving Sovereign Debt Crises: Towards a Fair and Transparent International Insolvency Framework', Friedrich Ebert Stiftung, September 2010, pp. 18-20, available online: http://www.eurodad.org/uploadedFiles/Whats_New/Reports/erlassjahr%20and%20FES%20study_Oct2010.pdf.

41 In 2002, the chief executives of five banks wrote to the then IMF Managing Director Horst Kohler challenging the assumptions underlying the proposal. See Ross P. Buckley, 'The Bankruptcy of Nations: An Idea Whose Time has Come', *The International Lawyer*, Vol. 43(3), 2009, pp. 1214-1215. Buckley argues that this intervention by the banks was both factually incorrect and short-sighted.

42 For second and third reasons, see Kaiser, 'Resolving Sovereign Debt Crises' op. cit., pp. 18-20.

CHAPTER 3:

The Case for a New Approach

‘When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor.’ Adam Smith, *The Wealth of Nations* (1776)⁴³

The late Walter Wriston, charismatic and influential banker of the 1970s and Citicorp Chairperson, famously declared that ‘countries never go bankrupt’.⁴⁴ Wriston’s quip was correct in one sense: without a court to administer bankruptcy, and rules to govern it, an entity cannot go bankrupt, only broke. But this fact is merely contingent upon the existing international financial arrangements— it need not necessarily be the case.

A growing number of people disagree with maintaining the status quo concerning sovereign debt management. They derive their arguments from three main perspectives. The first is associated with the idea that debtors have rights. While many of the proponents of this perspective share some underlying presuppositions with the dominant approach— particularly with respect to the history and causes of the debt and financial crises— their main concern is that the current system of debt management does not and cannot work because it is unfair. It is badly managed, does not respect debtor sovereignty, and unfairly hurts the people of debtor countries and thus is unacceptable from an equity/human rights perspective.

The second argument for a change in approach draws attention to the fact that the international financial system should concern itself as much with the moral hazard of creditors as with that of debtors. Without the threat of sovereign insolvency, creditors are all but absolved of responsibility for poor decisions. Furthermore, private financial institutions whose loans or investments go awry are being continually bailed out by the IMF and/or government rescue packages, while taxpayers of the borrowing country bear the financial and social cost. It follows that the current system, in turning a blind eye to the culpability of lenders, serves to encourage imprudent financial behaviour by lenders.

The third perspective frames its rejection of the status quo in the deeper structural analysis of development finance. It argues that the Bretton Woods Institutions, often under the influence of the most powerful shareholders (especially the US), have managed international debt crises poorly and at times have been partly responsible for creating the very crises they are supposed to manage. Being so implicated, their very legitimacy as global governance institutions must be strongly challenged in any attempt to reform the international financial system.

3.1. Debtors’ Rights

Systems of bankruptcy at the national level exist to divide the assets of an insolvent debtor fairly and efficiently between creditors, while protecting the debtor from a life of debt servitude (provided the debtor has not engaged in dishonest or otherwise improper financial conduct) and allowing the debtor the opportunity to make a fresh start. Yet when nations have unsustainable debts that make them effectively bankrupt, there is no alternative but to repay them. As Buckley says: ‘We still have something very like debtors’ prisons for highly indebted nations’.⁴⁵

The thrust of this argument is that the management of creditor-controlled debt mechanisms is poor.⁴⁶ More specifically:

1) the process is inefficient, unfair and imposed on debtors; 2) its mismanagement causes undue suffering; and 3) a different system is needed which respects the sovereignty of the debtors and the basic needs of their populations.

The Process is Inefficient, Unfair and Imposed on Debtors

The first grievance relates to the debt management process by which countries in financial trouble engage with the creditor clubs and the Bretton Woods Institutions (discussed in Chapter 1). In particular, there are two problematic aspects of the process:

1) Efficiency: Under the current system, debt management takes too long and is too complicated. It is fragmented between governmental creditors, commercial creditors and multilateral creditors, and the entire problem cannot be addressed all at once. It is interesting to note how these arguments are similar to some of the key arguments of the dominant approach, namely, a shared concern with inefficiency, except that in this case the emphasis is on the suffering caused by the inefficiency.

⁴³ Adam Smith, *The Wealth of Nations*, Edward Cannan ed., Book V, Chapter III, 1776, p. 468.

⁴⁴ As quoted by Jeffrey Sachs, *Developing Country Debt and Economic Performance*, Volume 1: *The International Financial System*, 1989, University of Chicago Press, Chicago, 1989, p. 8.

⁴⁵ Buckley, ‘The Bankruptcy of Nations: Let the Law Reflect Reality’, op. cit., p. 14.

⁴⁶ Thomas Fritz and Philipp Hersel’s FTAP paper has as its starting hypothesis that ‘the roots of the persistent failure to solve the debt crisis must be looked for in the mechanisms of debt management itself’ [our emphasis]. See Fritz and Hersel, *Fair and Transparent Arbitration Processes*, op. cit., p. 9.

2) Sovereignty: Debtor nations must either negotiate as a single poor country against a phalanx of rich countries (in the case of the Paris Club) or banks (in the case of the London Club). The creditors call the shots and essentially dictate the terms they will provide assistance to debtors. When seeking debt-relief status or emergency financing from the IFIs (as is the case with HIPC countries) access to debt relief/new finance is conditional upon fulfilling policy conditions which are essentially imposed by the Bretton Woods Institutions. In other words, debtors are forced into making policy choices that they are told are good for them, even though they may not agree.⁴⁷ In either case, debtors have little agency or power and are obliged to do what they are told to attain the assistance that they require.



June 2007, Germany. A public forum organised by civil society to coincide with the G8 Leader's Summit. Non-government representatives from Africa, Asia and Latin America share their analysis and experiences of the impacts of irresponsible lending and illegitimate debt on their countries. (Photo: Adele Webb, 2007)

Mismanagement Causes Suffering

Large quantities of ink have been spilt by civil society groups— especially before the Multilateral Debt Relief Initiative (MDRI) was finally announced in 2005— pointing out the evils and human suffering that results from the debt repayments forced on poor countries by their creditors. Long-term economic stagnation and social disruption, both of which perpetuate the suffering of indebted populations, result from a skewed idea of what is sustainable for a population to bear. This is a consequence of how the creditors have come to conceive of debt sustainability. A cornerstone of the current approach holds that debt relief or restructuring only be given when certain minimum thresholds are passed regarding a nation's debt service, as compared to its export profile (because debt is usually paid in foreign currency, which can only be 'earned' through exports).⁴⁸

A related critique is also made of the policy and budget restructuring that is mandatory when countries are forced to go to the IMF for help of any sort. Such 'adjustment' policies, including budget cuts and fiscal austerity, have been forced on poor countries in perennial debt distress, especially during the 1980s and 1990s. As Ngaire Woods has said, 'Study after study of the impact of adjustment in Africa and elsewhere pronounced adverse effects on the poor or at least highlight how little

⁴⁷ There has been a debate running about conditionality for almost three decades now. By the late 1990s, the IFIs responded with a new emphasis on country ownership of reforms that they were recommending. However, many have held that this was largely a rhetorical adjustment, and there was little change from the practice of imposing the same-size-fits-all, top-down solutions as before.

⁴⁸ The most comprehensive critique of this position remains Francesco Oddone. See Francesco Oddone, 'Still Missing the Point: Unpacking the new World Bank/IMF debt sustainability framework', EUROODAD Position Paper, September 2005, available online: http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Eurodad%20WB%20and%20IMF%20still%20missing%20the%20point.pdf. Also see Kaiser, 'Resolving Sovereign Debt Crises', op. cit., pp. 9-10.

attention has been paid to protecting the poor' (UNICEF's 1986 State of the World's Children Report being the paradigmatic example).⁴⁹ A similar criticism is made of the policies forced upon countries who, undergoing financial crisis, sought emergency help from the IMF, such as Indonesia and Argentina. These policies have been said to have worsened the crises by further increasing the economic downturn and thus the suffering of the people (see section 3.3 below).

Note that it is the suffering that these policies cause— not the illegitimacy of the institutions that prosecute them— that is the main concern in this case.

A Return to Dignity – Meeting Basic Needs

Those advocating from this perspective argue that debt service from less-developed countries in the Global South to countries/institutions or individuals in the Global North has affected the ability of the formers' governments to meet the needs of their citizens. A better solution is one that respects the sovereign right of debtor countries to protect their own people. Thus, solutions should allow debtor states the autonomy to solve their own problems and to prioritise their own budgetary needs according to principles of basic needs.

A debt mechanism should be tasked with quarantining spending for basic needs before determining what would be left over for debt repayments. According to Thomas Fritz and Philipp Hersel, 'debtor countries must focus their public spending on expenditures for basic needs before paying debt service. By focusing on basic needs, an insolvency mechanism can serve to overcome debt as a structural blockage of development'.⁵⁰

49 Woods, *The Globalizers*, op. cit., p. 158.

50 Fritz and Hersel go on to say that this would need to be integrated into an overall development strategy. See Fritz and Hersel, *Fair and Transparent Arbitration Processes*, op. cit., p. 46.

3.2. Creditor Moral Hazard

For every bad credit decision there are two culpable parties: the borrower and the lender. Yet as we have seen, the existing framework for sovereign lending and borrowing focuses exclusively on the role of the borrower in a sovereign debt crisis, and places the responsibility for making the situation right squarely at the feet of the indebted country and its people. This happens while the culpability of the creditor is ignored, and risky lenders are freed from taking responsibility for their poor decisions.

Returning to the history of debt and financial crises that have been discussed throughout this paper, a consistent pattern emerges: poor investment decisions go unpunished. For example:

In the 1980s debt crisis, overexposure of private banks in Latin America left a well-marked trail back to the US. Not only was the over-enthusiastic lending of the 1970s due to official encouragement (as described in the next section), the financial institutions themselves are to blame. By the 1970s, the US private banking sector had forgotten the lessons of the Great Depression— they had a skewed incentive system that encouraged reckless loans, a great deal of money, and nowhere else to go with it. The result was many careless loans.

Huge Japanese financial flows to peripheral Asian economies were the proximate cause of the Asian Financial Crisis of the late 1990s. Unfortunately, many of the loans had been to domestic banks, especially in Indonesia and South Korea, which, in turn, had not been prudent in their lending to local business and personal clients. The currency troubles of Thailand, South Korea and Indonesia put even more pressure on the indebtedness of the domestic businesses, and the local banks which had lent to them. Yet the injections of emergency cash into Indonesia and South Korea from the IMF and donor governments that were intended to shore up this domestic financial situation did nothing of the sort. The emergency packages repaid foreign investors, who took their money and left, leaving local financial institutions and businesses bankrupt and severely affecting the livelihoods of citizens. Although the IMF erred in allowing the overseas creditors (mainly banks) to pull out their money so quickly, the creditors should have borne some of the responsibility for the poor lending decisions they had originally made. Instead, they were able to escape relatively unscathed while the people of Indonesia, South Korea and Thailand were left to bear the brunt of the costs.

The recent decision by the government of Ireland to guarantee the obligations of the Irish banks would have made some sense if, as it was claimed, the future of Irish businesses and the livelihoods of Irish households were at stake. However, this was far from the case. The bondholders who held so much of the banks' debt were German and French banks, German investment funds and the investment bank Goldman Sachs. The Irish bailout was a bailout principally of foreign banks. A similar story is true of Greece. Greek government budgets were reasonably well-balanced in the 2000s, despite claims in the financial press that public financial mismanagement was the main cause of the Greek debt crisis. The crisis, in reality, was due to the liquidity provided by the European Central Bank during the credit crunch, and a large increase in lending by the Greek government to keep the economy going in light of the global economic downturn. As shown by the RMF report, *The Eurozone Between Austerity and Default*, the real concerns of the EU and the ECB at the time was not the tiny (110 billion Euro) bailout to Greece, but the much larger (750 billion Euro) bailout for the entire Eurozone announced later that month. As the report says:

Although the rhetoric of European leaders was about saving the European Monetary Union by rescuing peripheral countries, the real problem was the parlous state of the banks at the core. The intervention was less concerned with the unfolding disaster in Athens and more worried about European (mainly German and French) banks facing a wave of losses and further funding difficulties.⁵¹



Photo: End of Poverty? Think Again by film director Philippe Diaz
www.theendofpoverty.com

In summary, history and analysis do not allow the problem of creditor moral hazard to be ignored. The international financial system would be far more stable if capital only flowed after more careful credit decisions. Fewer international

⁵¹ Lapavistas et al, 'The Eurozone Between Austerity and Default', op. cit., p. 29. This analysis has been supported by Lord Robert Skidelsky, who said in a recent speech: 'The intervention packages of May 2010 have been ostensibly directed to securing the solvency of the peripheral states, but were in practice aimed at restoring the solvency of the banks which had overlent to them.' See Robert Skidelsky, 'Europe's Debt Crisis and Implications for Policy', Keynote Speech at FT Conference in Amsterdam, 14 September 2010, available online: <http://www.skidelsky.com/site/article/europes-debt-crisis-and-implications-for-policy/>.

rescue packages (primarily facilitated by the IMF) would mean that creditors who advanced short-term debt— the most destabilising form of debt for a nation— would no longer be continually bailed out. And the negative impact of higher credit costs for developing countries would be ameliorated by the lack of consistent financial crises that would result from more prudent financial behaviour by lenders.

3.3. The Bretton Woods Institutions – Creating and Prolonging Crises

Complicity of International Financial Institutions in the First Debt Crisis

Even before the 1970s, the Bretton Woods Institutions helped to create the very situation of indebtedness that they themselves had responsibility for fixing. This happened in two main ways.

First, the IMF consistently required the opening up of foreign countries to overseas investment as a quid pro quo for being granted access to foreign aid (which it controlled). The institution used its policy clout to force countries to let in more foreign investment, often in ways that worsened, rather than improved, their foreign exchange profiles.⁵²

Second, the World Bank was aware by the mid-1960s that developing countries were over-borrowing and may never be able to repay the loans.⁵³ Nevertheless, the Bank— with the support of powerful donor governments— continued to recommend more lending in spite of this looming crisis.⁵⁴ This pattern, whereby profligate lending was encouraged by donor governments in partnership with the Bretton Woods Institutions, was repeated with the petrodollar boom in the middle of the 1970s.

As discussed above, the 1973 oil shock contributed to an already booming trade in bank loans to the 'Third World'. Henry Kissinger's statements to the UN on the matter make it clear that the US explicitly endorsed the practice of recycling.⁵⁵ Importantly, the lending spree of the private banks to Latin America and elsewhere during the 1970s was implicitly and explicitly endorsed by both the Bank and the Fund. The IMF's 1975 Annual Report was extremely supportive, even bullish, about the recycling of the petrodollars to developing countries and the IMF actively encouraged private banks to continue and increase their lending after the first OPEC price hike in 1973/4.⁵⁶ Policymakers, whether working for domestic governments or the IFIs, were concerned about improving G8 trade imbalances that were resulting from the price increase in oil imports and avoiding a resulting global recession. The real needs of developing countries were of secondary importance.⁵⁷

None of this absolves the private banks from their share of the responsibility. Even though governments and the IFIs expected banks to recycle Euros and petrodollars, the banks were also greedily interested in their own profits.⁵⁸ Still, the World Bank and the IMF knew by the early 1970s there was already a debt crisis in many developing countries. It was already clear at this time that there were problems with the development model, and that a change in approach was necessary. But the World Bank and the IMF, along with powerful domestic forces, pushed through further rescheduling and more (often publicly guaranteed) lending by private banks, principally to serve interests within G8 countries.

'Third World' Debt Crisis: Bretton Woods Institutions Prolong the Crisis

When we look at Africa, the debt crisis for the poorest countries worsened throughout the 1980s and 1990s. Sub-Saharan African debt levels doubled between 1985 and the early 1990s while debt levels of the poorest (HIPC) countries in 1999 were four times their 1980 level.⁵⁹ By prioritising repayments over meeting basic needs, the advice of the international financial institutions helped prolong the debt crisis and caused enormous suffering. A rigid definition of debt sustainability was to blame, as were fluctuating and often falling commodity prices.

Most significant in the case of sub-Saharan Africa were the harmful effects of the World Bank-supported Structural Adjustment Programs and IMF conditionalities. These Structural Adjustment Programs resulted in a number of

52 This quote is from Payer, *Lent and Lost*, op. cit., p. 78. However, the argument is more fully developed in her earlier monograph on the IMF; Payer, *The Debt Trap*, op. cit., especially Ch. 1 and 2.

53 Many of its own Annual Reports throughout the 1960s had in fact been highlighting the danger of debt stocks that were continuing to rise. See Payer, *Lent and Lost*, op. cit., pp. 55-56.

54 Task Force on International Development (Peterson Commission), 'United States Foreign Assistance in the 1970s: a new approach', Report to the President, Government Printing Office, Washington, 1970, p. 10 cited in Payer, *Lent and Lost*, op. cit., pp. 58-59.

55 Payer, *Lent and Lost*, op. cit., p. 74.

56 Ibid., pp. 73-74.

57 Philip Wellons' in depth study on the interactions between financial institutions and governments suggests that governments were heavily involved in the banks' recycling of petrodollars, aware that if such recycling did not take place, their trade imbalances would worsen. Philip A. Wellons, *Passing the Buck: Banks, Governments and Third World Debt*, Harvard Business School Press, Boston, 1987, see especially pp. 58-63.

58 On the complicity of the banks, see Benjamin Cohen, *In Whose Interest? International Banking and American Foreign Policy*, Yale University Press, New Haven and London, 1986; and Susan George, *A Fate Worse Than Debt: A radical new analysis of the Third World debt crisis*, Penguin Books, London, 1988.

59 Woods, *The Globalizers* op. cit., pp. 146-147, 168.

problems stemming from an obsession with reducing budget deficits, which in turn, reduced the resources available for governments to invest in local development. The push to privatise government-owned services had long-term negative effects, including the creation of artificial monopolies and more expensive basic services such as water and electricity. Slashing public spending to reduce budget deficits caused unemployment to increase, hurt the economy and led to many personal hardships. Premature financial and exchange-rate liberalisation – before there was stabilisation in the economy – had negative monetary effects. And enforced trade liberalisation before the infrastructure and industries could adapt to world competition demolished many local industries. Apart from hitting the poor worst of all, these policies entrenched patrimonial politics in Africa and centralised power in the hands of those who already had more than enough of it.⁶⁰

In sub-Saharan Africa, scholars have laid the following charges concerning the failures of World Bank and IMF-imposed Structural Adjustment: it 'did not seem to work', had 'no impact on investment flows', had 'pronounced adverse impacts on the poor' or paid little attention to them, was 'deeply damaging, incurring perverse effects and hindering the prospects of development outcomes', and 'ignored or wished away political realities'. Similar critiques have been made about World Bank and IMF policies in Latin America and many poorer Asian countries. These were often bigger economies with more complex debt profiles. But the central point is this: the African crisis worsened through the 1980s and 1990s and the Bretton Woods Institutions were contributors to it.⁶¹

The Role of the IMF in Increasing Financial Vulnerability in the 1990s

A number of the patterns discussed above in relation to the 1980s debt crisis have also been observed in the recent financial crises, in particular with the IMF. As with the earlier debt crises, the IMF had a large role in making various nations vulnerable to financial crisis by forcing the premature opening up of economies to foreign capital. The countries concerned did not have systems in place to contend with the sudden influx of capital. This left them vulnerable to sudden flight when factors in the global economy turned against them. In East Asia, the IMF was also pivotal in urging Asian economies like Malaysia, Thailand, South Korea and Indonesia to relinquish their capital controls to allow foreign investment.⁶²

The IMF, while important, was not the only factor at play in the decision by countries to drop capital controls and embrace foreign investment. Asian economies were vulnerable to the vicissitudes of international capital mobility due to the weakening of the developmental state. In South Korea, for example, the retreat of government officials from their central role in development policy and a consequent lack of competitiveness of the Korean chaebols (large, conglomerate family-controlled South Korean firms) led to poor investment decisions on the part of the powerful chaebols, which became over-leveraged with foreign debt. This process was influenced by neoliberal economic orthodoxy among Korea's bureaucratic elites and made Korea particularly vulnerable when the Asian financial panic hit.⁶³

The IMF role in encouraging the abandonment of capital controls and the widespread adoption of a model of economic growth based on foreign investment was perhaps most explicit in Argentina. Argentina was the IMF's poster child in Latin America because it had followed its economic prescriptions to the letter. The IMF advised Argentina to peg its exchange rate to the US dollar and open up its capital markets, causing a huge influx of overseas capital into the economy. Together, these two policies made Argentina vulnerable to any slight change in the global economy. When the US dollar rose, Argentine exports became less competitive, the economy tanked, foreign investors fled, and Argentina was left with a huge debt headache.

Unwise Interventions in the Asian Financial Crisis

As with the 1980s debt crisis, the IMF bears some responsibility for worsening the recent financial crises with poor policy prescriptions. The three main criticisms regarding IMF actions during and immediately after the Asian Financial Crisis include:

Austerity

The typically severe austerity policies that the IMF imposed upon East Asian economies, such as budget cuts and high interest rates, were damaging in a number of ways. Contractionary policies, rather than counter-cyclical deficit spending, worsened recessions in the countries involved, and the advice to hike up interest rates in an attempt not to lose foreign

60 For the best synthesis of these points, see Woods, *The Globalizers*, op. cit., chapter on Africa; and Ha-Joon Chang, *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism*, Bloomsbury Press, New York, 2008, in particular Ch. 5 and 7.

61 Woods, *The Globalizers*, op. cit., Ch. 6, pp. 141-178.

62 For the most classic statement of this see Stiglitz, *Globalization and Its Discontents*, W. W. Norton and Company, New York and London, 2002, pp. 98-104.

63 The contrast can be seen with Taiwan, which for various reasons resisted IMF advice to liberalise its capital controls and was thus in a much safer position when the crisis hit. See Linda Weiss, 'State Power and the Asian Crisis', *New Political Economy*, Vol. 4(3), 1999, pp. 317-342; and Ha-Joon Chang, 'Korea: The Misunderstood Crisis', *World Development*, Vol. 26(8), 1998, pp. 1555-1561.

investors (which did not work anyway) simply worsened recessions by causing local businesses to go bankrupt.⁶⁴

Inept Financial Restructuring

In some countries, most notably Indonesia, an ill-timed and unnecessarily doctrinaire attempt to reform the private banking sector caused the massive collapse of banks. This wrought devastation throughout the entire economy, again deepening the country's recession. Similarly, the IMF's insistence on corporate restructuring of insolvent firms, managed from the outside, often resulted in the buying up of business assets at 'fire sale' prices and the transfer of previously domestic-owned assets abroad.⁶⁵

'Bailing-Out' Versus 'Bailing In'

The actions of the IMF effectively led to the 'bailout' of foreign banks which had invested in East Asian economies. It is instructive to compare the behaviour of the creditors during the Mexican Tequila crisis of 1995 with actions during the Asian Financial Crisis of 1997/8. In the former case, the US organised a massive emergency injection to defend the currency and reassure overseas investors, accompanied by a requirement that banks do not remove their money (i.e. loans had to be rolled over). Critically, these measures were not applied three years later during the Asian crisis.

There have been various interpretations of this inaction. Some analysts have laid the blame on IMF hubris, suggesting that it naively thought that its involvement in the Asian Crisis should have been good enough for foreign investors to keep their money in.⁶⁶ Other analysts have suggested that the US should be seen as behind this decision (given that the weakening of economies like South Korea could potentially benefit Wall Street and therefore US national interests).⁶⁷ But whether overconfidence or subservience to its most powerful shareholder was the cause, the decision was a damaging one and another indictment of the IMF's poor handling of the crisis.

Austerity in the Eurozone

In Greece, Ireland, Spain, Latvia and Portugal the IMF is currently involved in the implementation of pro-cyclical policies (austerity, anti-labor reforms and privatisations).⁶⁸ As a result, these countries must suffer through years of continued unemployment (20% in Spain, 15% in Ireland, 11% in Portugal, 17% in Latvia and 14% in Greece). An RMF report identifies two important aspects of the Eurozone austerity packages adopted in Europe. First, most of the austerity measures (wage cuts, public spending cuts, pension freezes) will fall hardest on working people, since such measures are designed to serve the dual purpose of reducing fiscal deficits and cutting labour costs to make the economies more competitive.⁶⁹ Secondly, the measures are part of a broader liberalisation strategy to reduce the role of the state in the economy.

The authors of the RMF report argue that the strategy is unlikely to succeed because these economies will not be able to improve their competitiveness against Germany. Yet failure will see these countries paying a high social cost for years to come. The Center for Economic and Policy Research's Mark Weisbrot believes that these policies are risky and unnecessary as

... the fund's policies still reflect the creditors' point of view. And from the creditors' point of view, a country like Greece— whose debt even the financial markets recognise it will have to restructure at some point — must first go through hell. The European authorities and IMF together have so much money (\$750bn for the IMF, \$635bn for the European Financial Stability Facility and \$87bn for the European Financial Stabilisation Fund) that it would be quite simple to painlessly rescue the relatively small economies of Greece, Ireland, Portugal, or Latvia— or even the much larger Spanish economy, restoring growth and employment first and worrying about the debt after the economy is on track.⁷⁰

In summary, the Bretton Woods Institutions, though purporting to be the key actors in resolving sovereign debt and financial crises, have in fact been implicated in causing these crises, particularly through the insistence on premature removal of capital controls. The institutions' mismanagement of the response to the crises stemmed from a rigid definition

64 According to Stiglitz, the IMF was supported in its position on contractionary austerity policies by the US Treasury. See Stiglitz, *Globalization and Its Discontents*, op. cit., p. 106. Stiglitz goes on to argue that this advice was augmented by an obsession to immediately improve each country's trade deficits. Such a move could only be achieved by cutting imports, which had the effect of worsening export profiles of neighbours, thus worsening the region-wide crisis, pp. 106-109. On the negative impact of interest rates see pp. 109-113.

65 See Stiglitz, *Globalization and Its Discontents*, op. cit., pp. 113-118. On the corporate restructuring see Robert Hunter Wade and Frank Veneroso, 'The Asian Crisis: The High Debt Model versus the Wall Street-Treasury-IMF Complex', *New Left Review*, Vol. 228, 1998, pp. 3-22.

66 Andrew Sheng, *From Asian to Global Financial Crisis: An Asian Regulator's View of Unfettered Finance in the 1990s and 2000s*, Cambridge University Press, Cambridge, 2009, p. 113.

67 See Weiss, 'State Power and the Asian Crisis', op. cit., pp. 331-336.

68 Greece, Latvia, and Romania are operating under IMF agreements. Spain, Ireland, and Portugal do not have agreements with the IMF, but the Fund, in coordination with the European authorities, is involved in the determination of macroeconomic policy in these countries. See Mark Weisbrot and Juan Montecino, 'The IMF and Economic Recovery: Is the Fund Contributing to Downside Risks?', Center for Economic and Policy Research, Washington D.C., October 2010, available online: <http://www.cepr.net/documents/publications/imf-and-economic-recovery-2010-10.pdf>.

69 Lapavistas et al, 'The Eurozone Between Austerity and Default', op. cit., pp. 39-43.

70 Mark Weisbrot, 'Emerging Out of the IMF's Shadow', *Guardian Online*, 18 April 2011, available online: <http://www.guardian.co.uk/commentisfree/cifamerica/2011/apr/18/imf-international-monetary-fund>.

of 'debt sustainability', poorly managed (and excessively rigid) macro- and microeconomic policy advice (including insistence on contractionary policies) and, in the case of East Asia, bailouts of the private banks. These blunders no doubt resulted from an overly zealous belief in free market philosophies and the malign influence of the institutions' major shareholders, particularly the US.



Sellers in Divisoria, Manila's busiest marketplace (Photo: Chih Yung Jon Fang)

CHAPTER 4:

An International Arbitration Mechanism for Sovereign Debts

four

This paper has demonstrated the need for a new framework to replace existing mechanisms and the dominant approach to sovereign debt management. Lessons drawn from the evidence presented in Chapter 3 may be summarised thus:

First, debtors have rights. Countries experiencing debt or financial crises should have greater responsibility and autonomy when it comes to making decisions about how to respond to and manage the debt or financial crises affecting them. Moreover, without this autonomy their populations are even more vulnerable to decisions that affect their livelihood and human rights.

Second, the problem of creditor moral hazard is real and should be of even greater concern than debtor moral hazard. A system has been created whereby creditors (countries, banks, and bondholders) are not held to account for the poor investment and financing decisions they make. This needs to change.

Third, steps must be taken to alter the extent and nature of the role of Bretton Woods Institutions in economic decisions of poor and vulnerable countries. Though purporting to be the key actors in resolving sovereign debt and financial crises, Chapter 3 has shown how they have caused and prolonged these crises, and were proponents of bad policy.

4.1. How It Would Work

The proposal for an international arbitration mechanism is the most popular and comprehensive model for a sovereign insolvency regime. It is a proposal that enjoys widespread support from many individuals and groups within civil society. First raised in the 1970s, the proposal has a long pedigree.⁷¹ It draws most strongly on two legal precedents: 1) US bankruptcy code which provides a tried and tested model of insolvency for government authorities such as states and municipalities; and 2) a long tradition of international arbitration as a means of settling disputes at the international level. In terms of the actual mechanism, the relative merits of an ad hoc tribunal or a permanent court are discussed below.

Legal Precedents

US Bankruptcy Code

Most countries have bankruptcy laws that regulate the process to be followed when a firm becomes insolvent. In the case of the US, these processes are laid out in Chapter 11 of the bankruptcy code. However, in Chapter 9 (Title 11), the US also makes provisions for a process whereby municipalities can declare insolvency. Unlike firms, municipalities cannot be liquidated and their assets sold off to help creditors recoup their losses. The law provides an extra level of protection to keep the municipality functional while enabling the authority to avoid sacrificing any of its basic functions for its citizens in order to pay off debts. In this sense, Chapter 9 might be said to be the ideal vehicle when it comes to the desire to provide debtor protection.

Although Chapter 9 under the US bankruptcy code is not used as often as its Chapter 11 counterpart, proponents point to a series of cases where Chapter 9 has been successfully applied to insolvent municipal authorities. Although the settlements differ from case to case, in most circumstances creditors are forced to write off significant parts of their debts.⁷² One of the earliest proponents for the adoption of Chapter 9, Professor Kunibert Raffer, has asked the question: 'If freeing debtors from oppressive debts and safeguarding their human dignity during the proceedings makes economic sense in the North, why not in the South?'⁷³

International Arbitration

Arbitration has a long history in international law and the long-established Permanent Court of Arbitration in the Hague has been operating since 1920. Arguments draw on this long tradition of arbitration as a mechanism for dispute resolution. The recent proliferation of bodies that use arbitration law and procedures to settle financial and investment disputes also draws on this tradition.

There are a number of arbitration frameworks that exist, including commercial arbitration procedures at the International Chamber of Commerce and the Model Law on International Commercial Arbitration at UNCITRAL. Also, the World Trade Organisation's dispute settlement procedures and the World Bank's International Centre for the Settlement of Investment Disputes (which often rules in favour of developing countries when disputes occur) both provide models for successful international arbitration processes.⁷⁴

⁷¹ The Group of 77 (G77), the developing country-negotiating block within the UN, tried to get the principle of an International Debt Commission established back in 1979 at the UNCTAD meetings in Manila. See Rieffel, *The Role of the Paris Club in Managing Debt Problems*, op. cit., pp. 23-25.

⁷² Nevertheless, Raffer argues that these settlements are fairly equivalent to those of an average Chapter 11 settlement. See Kunibert Raffer, 'Applying Chapter IX Insolvency to International Debts: An Economically Efficient Solution with a Human Face', *World Development*, Vol. 18(2), 1990, pp. 302-303.

⁷³ *Ibid.*, p. 303.

⁷⁴ For a more in-depth discussion of the history of international arbitration, see Fritz and Hersel, *Fair and Transparent Arbitration Processes*, op. cit., pp. 28-33.

Mechanisms Proposed

An Ad Hoc Tribunal

The more modest proposal is for an ad hoc arbitration process to resolve sovereign insolvency. The push for an ad hoc tribunal likely began with the aforementioned Kunibert Raffer, the original champion of the Chapter 9 approach discussed above. A paper by Philipp Hersel and Thomas Fritz published around the same time the IMF was proposing its SDRM also highlighted the need for ad hoc arbitration— a cause subsequently taken up by the Jubilee movement. The authors drew significant inspiration from Raffer's conceptual idea of the role of the Chapter 9 principle in US domestic law and on the evolution of arbitration through the history of international dispute settlement.

A Permanent Standing Court

Not all experts, however, agree that an ad hoc tribunal is preferable to a permanent one. A number of academics and civil society groups have proposed that instead of an ad hoc process, a permanent standing court (or International Insolvency Court) be adopted. For example, Latin American economists Oscar Ugarteche and Alberto Acosta made a case for a debt tribunal in 2003. Around the same time, African civil society coalition AFRODAD held conferences on the topic and proposed the establishment of a tribunal at the Permanent Court of Arbitration in the Hague.⁷⁵ More recently, academics Christoph Paulus and Steven Kargman, and Professor Ross Buckley have made the case for a permanent tribunal.⁷⁶

Proponents make two separate arguments for a standing court over an ad hoc approach. First, an ad hoc arbitration mechanism could more easily be manipulated by powerful creditors to serve their interests. Thus a permanent court would provide 'politically and economically weak indebted countries' with more legal security.⁷⁷ Secondly, an ad hoc mechanism will need to create a 'selected pool' of expert arbiters with knowledge and experience in the area. It will be difficult to develop expertise within this limited pool, thus creating the prospect of inconsistency in the rulings of different panels.⁷⁸

Making It Happen

An excellent discussion of the pros and cons of these two models is found in the recent Resolving Sovereign Debt Crisis report. Although both models have strengths and weaknesses, the report suggests that the way forward is to strike while the iron is hot and use the current period of financial uncertainty to get an ad hoc body up and running, with the hope of moving towards a more formal standing court as a longer term goal.⁷⁹ To this end, the paper lays out a fourteen-point plan for the establishment of an ad hoc arbitration process in the coming one to two years. The central actors in the plan are the ministries of finance in countries facing debt-distress. The first steps involve the finance ministry notifying its creditors of a stay of payments and then its intention to resolve debt via an independent arbitration procedure. The setting up of an arbitration panel would follow.⁸⁰

Legitimacy of Claims

This paper has demonstrated that there is much more to the story of the 'Third World' debt crisis than the simplistic interpretation of rich-country charity being wasted on the poor. History and analysis reveal that one of the root causes of 1980s debt crisis, repeated in the recent European experience, was unquestionably poor quality finance. A fundamental agreement of international debt campaigners is that debts found to be illegitimate should be cancelled immediately and without conditions. Such a position arises from the contention that those governments and institutions lending to less-developed countries, often in the name of 'development', should share responsibility for self-interested or poorly conceived loans and should pay the outstanding costs of the illegitimate debts created. Yet Norway remains the only country to have voluntarily acknowledged this, when in 2006 the government cancelled debts shown to have arisen from loans that were made more for the purpose of boosting domestic exports than to serve the development needs of the recipient country.

An independent arbitration mechanism could go beyond issues of debt sustainability, providing a forum to verify individual creditor claims according to clear and predictable criteria for illegitimate debt. A key strategy of civil society organisations has been the pursuance of sovereign debt audits. Audits conducted to date, both by governments and citizen groups, have provided valuable evidence which could be used to inform independent arbitrators' decisions. For the first time, creditors would be held responsible for financing activities that are legal and viable. Looking forward, it would create clear incentive for lenders to behave in a more cautious and responsible way.

⁷⁵ Kaiser, 'Resolving Sovereign Debt Crises', op. cit., p. 20.

⁷⁶ Christoph G. Paulus and Steven T. Kargman, 'Reforming the Process of Sovereign Debt Restructuring: A Proposal for a Sovereign Debt Tribunal', presentation to the United Nations Workshop on 'Debt, Finance and Emerging Issues in Financial Integration', New York, April 8-9, 2008; and Buckley, 'The Bankruptcy of Nations: An Idea Whose Time Has Come' pp. 1189-1216.

⁷⁷ Kaiser, 'Resolving Sovereign Debt Crises', op. cit., p. 20.

⁷⁸ See Paulus and Kargman, 'Reforming the Process of Sovereign Debt Restructuring', op. cit.

⁷⁹ See Kaiser, 'Resolving Sovereign Debt Crises', op. cit., p. 20. Kaiser's article has an excellent list of pros and cons for the two arguments, p. 21.

⁸⁰ Ibid., pp. 29-31.

Box 2: A Menu of Deeper Solutions

Larger challenges call for a reconsideration of how development finance might work better for the poor. A menu of deeper solutions is needed, aimed at reintroducing autonomy to the model of development.

The raft of measures suggested below would have profound implications on the nature of the global financial system. Indeed, that is the very point of them. One of the most profound would be a necessarily reduced role of the International Financial Institutions that have championed the very policies that this set of measures seek to replace. Both the IMF and the World Bank rely on lending, on policy conditionality and on repayment of all their loans. They have been the driving forces towards the opening up of domestic markets to foreign capital and in many cases against the use of domestic resource mobilisation. These measures would reduce their roles and their ability to determine policy.

A further consequence of these reforms would be the redefinition of the role and activities of Southern elites. Should these policies be adopted, Southern elites would have to become more accountable to their citizens, more reliant on working with their own people in bringing about sustainable development, and less reliant on partnerships with overseas capital and on advice from overseas financial and development 'experts'.

Less of a Reliance on Loans

One of the most obvious ways to break the loan cycle is to severely curtail the use of loans for development purposes and make a deliberate move to grant-based financing. 'Successful' development initiatives, like the Marshall Plan, did not use loans, and there is reason to believe that early development thinkers also favoured grants. Many countries, including Australia, have turned away from using loans in their aid programs (although such countries often still use trade credits as a de facto, self-interested, form of development lending). An entire new source of loan-based development financing is opening up, with some multilateral institutions maneuvering to make much-needed climate change adaptation financing available to vulnerable countries in the form of loans. Needless to say, the use of loans to confront the challenge of climate change will only worsen future debt crises.

Criteria for Responsible Financing

Accompanying this call for less lending in toto is an accompanying recommendation that rigorous and enforceable criteria be adopted for the development loans that are used. Loans from developed countries and financial institutions to less-developed countries should be subjected to a much higher level of transparency and accountability than has historically occurred. This would enable populations in countries who are supposed to be the beneficiaries of such projects to be able to track whether the supposed economic benefit has taken place that would justify the debt that their government has taken on. A concrete list of such criteria has been provided by EURODAD with its Charter for Responsible Financing.

An End to Policy Conditionality

As explained earlier, World Bank/IMF policy conditionalities associated with access to new loans and debt relief have been criticised for the damage they have caused in less-developed countries. At a more general level though, these conditionalities arise through two main structural flaws embedded within the IFIs themselves.

There exists a flaw relating to the institutional modus operandi of the IFIs. The IFIs favour one-size-fits-all models for development. Related to this bureaucratic flaw is an additional flaw: the Bretton Woods Institutions are dominated by an approach to economic development that favours open markets, free trade, financialisation, export-led development and are against exchange rate control, controls on imports and a graduated entry into the global economy. There is evidence that the IMF, for example, is still exerting this sort of policy control via emergency finance in the current crisis. At the heart of the legitimacy critique is the argument that the financial leverage that the IFIs brandish is a violation of sovereignty and a way for creditor countries to impose unacceptable policy reforms on less-developed countries by stealth (although often with the support and even cooperation of the countries' own elites), and that such practice must stop.

No More Sovereign Guarantees

Another important aspect of this approach would be an end to the use of sovereign guarantees from developing country governments to corporations that have taken out loans from overseas financiers. The justification for this move goes further than the fact that such sovereign guarantees have been responsible for the creation of so much of the problematic debt. It would also send an important message to overseas financiers: the project or the concern being financed should be able to produce a return on the investment, and if the returns do not materialise, the investors should know that they will have to bear the costs of such a poor financing decision. In other words, if there are doubts about a concern being financed such that a sovereign guarantee is thought necessary, then either the investment should not be made or the investors should bear their share of the costs of such a risky investment.

Domestic Resource Mobilisation

There is a lot of evidence that the supposed connection between overseas investment and sustainable development is both tenuous and self-serving. In this sense, the solutions proposed focusing on domestic resource mobilisation would seem to be much more productive. The improvement of global tax regimes and the end of transfer pricing by multinational companies are both achievable goals, as is the increasing revenue transparency from rents in resource-rich developing countries.

Reintroduction of Capital Controls

As we have seen, the use of bond financing has become very popular with developing countries since the 1990s. This has been made possible partly because of pressure from outside institutions like the IMF to end the use of capital controls and open up financial markets to foreign investors. However, it is not yet clear that this move is always appropriate and there is increasing evidence that removing capital controls should be done gradually and carefully, if at all.

4.2. Implications of an Arbitration Mechanism

Introducing an international insolvency regime would be an important step toward an international financial system that is more predictable, fair and conducive to development. The procedure for resolving debt payment difficulties would be fundamentally different from existing mechanisms in that it would:

- 1) give priority to a governments' obligations to meet the essential needs of its citizens;
- 2) discipline imprudence on behalf of both lenders and borrowers;
- and 3) elevate debt restructuring decisions to a neutral and legitimate forum.

What an Insolvency Mechanism Will Do

1) Secure More Debtors' Rights

In the way national insolvency laws protect businesses and individuals in the event of bankruptcy, an international insolvency regime will fairly and efficiently restructure sovereign debts, while ensuring the government is left with enough resources to meet the basic needs of the people. As Fritz and Hersel have said: '... debtor countries must focus their public spending on expenditures for basic needs before paying debt service. By focusing on basic needs, an insolvency mechanism can serve to overcome debt as a structural blockage of development'.⁸¹

2) Lessen Creditor Moral Hazard

Beyond the short-term, when it is reasonable to expect some uncertainty, the existence of an international insolvency mechanism will make for a far more stable, predictable and fair international financial system. In particular:

- Capital would flow only after more careful credit decisions;
- Less need for international rescue packages (primarily facilitated by the IMF) would mean those creditors who advance short-term debt— the most destabilising form of debt for a nation— would cease to be continually bailed out; and
- The negative impact of higher credit costs for developing countries would be ameliorated by the lack of consistent financial crises resulting from more prudential financial behaviour by lenders.

Profligate borrowing of irresponsible debtors will also be reduced with the introduction of this mechanism as more scrutiny is applied to the legality and viability of borrowing and lending decisions.

3) Impartiality and Reduced Influence of the Bretton Woods Institutions

A new insolvency regime would secure the legal right of debtors to an impartial judgement and weaken the dominance of creditors. Moreover, the IMF and World Bank's power to infringe the sovereignty of vulnerable countries would be significantly reduced, since their ability to impose 'adjustment' programs on governments is greatly enabled by their central role in the existing mechanisms for debt management.

What An Insolvency Mechanism Will Not Do

It is important to recognise that an international arbitration mechanism alone will not solve the problem of the continuing impoverishment and indebtedness in the world's poorest countries.

First, given the current international economic order and the dominance of creditors in existing debt management mechanisms, it needs to be considered whether traditionally subordinate countries will feel sufficiently empowered to use this new debt forum. The debt of the poorest countries has been predominantly created through aid flows and trade finance from rich country aid, export credit agencies, and powerful multilateral institutions such as the World Bank and other development banks. Given the power asymmetry between the creditor and borrower associated with these types of



Supporters of Erlassjahr (Jubilee Germany) travelled to Rostock in the far north of Germany, to participate in the mass public demonstration coinciding with the 2007 G8 Leaders summit taking place in the nearby seaside resort town of Heiligendamm. They carried over 500 large red balloons through the crowd, each signed by thousands of supporters, calling for the G8 country leaders to 'Wipe out Illegitimate Debt'. (Photo: Adele Webb)

⁸¹ Fritz and Hersel go on to say that this would need to be integrated into an overall development strategy. See Fritz and Hersel, *Fair and Transparent Arbitration Processes*, op. cit., p. 46.

Box 3: Sovereign Debt Default: A Time-Honoured Tactic

'Debt is not sacred. The USSR defaulted, China defaulted, American states defaulted, the Penn Central and the WPPSS defaulted. Default is as capitalist as apple pie.'

Henry Breck, The Wall Street Journal

A nation is in default when it stops meeting its payments (interest, amortisation, or both). This may happen for reasons beyond the nation's control (i.e. no reserves to pay) or it may be a deliberate strategy. Repudiation is a deliberate decision not to repay and is a rejection of the very obligation to repay.

Sovereign debt default has a long history, as does default by other non-national government authorities. It is in fact a time-honoured tactic through which debtors can negotiate better terms, including sovereigns. For example, it was used by Mississippi and Louisiana (1839), several Latin American states in the 1820s, the 1870s and again in the 1930s. As Ross Buckley says, 'In the overall majority of sovereign debt crises, from the sixteenth century to the twentieth century, sovereign debtors defaulted on their debts'.

Yet in contrast to the historical pattern of default, in the past 25 years countries have been hesitant to stop servicing their debts and sovereign defaults have been relatively rare. One significant reason very few countries default on their debts is the same reason much of the Global South's debt is illegitimate or odious: political power of elites in indebted countries have personal interests that are tied to the interests of foreign creditors. As Ross Buckley asks: 'Why would the elites in the debtor nations seek to stop the merry-go-round and get off? The ride is too lucrative'. In Latin America, for example, the richest 10% were made by the debt crisis. In the words of Professor Bresser Pereira, former Finance Minister of Brazil: 'The elite in general in the debtor countries are certainly not the ones that suffer most from the debt crisis; on the contrary, part of them is taking advantage from the debt'. Servicing foreign debts is usually in the personal and economic interests of the elites, though ultimately not in the best interests of the majority of people who have to be 'less healthy, less educated and less well nourished to enable the debt to be repaid'.

Another reason very few countries default is the success of creditors, often reinforced by political pressure brought to bear by the US and other foreign governments, in claiming that default and/or repudiation would have devastating financial and political costs for indebted countries, and is therefore not in the nation's best interests. They point to two main reasons why countries should service their debts: reputation and potential exclusion from global capital markets, and secondly, the threat of sanctions.

Yet history contradicts these threats. As Ross Buckley argues, 'the avoidance of the need to service current debt can often more than offset the benefits of new indebtedness... [for example] from 2001 to 2005 Argentina was in the same net cash flow position from having no access to new money and not servicing its debts.' Furthermore, financial markets tend to have a short memory because they make their decisions based on prospective returns. A nation's payment history is just one factor in determining the flow of capital into a region. Less than half a decade after 1982, nations that had defaulted or delayed their debt repayments were in positions to those who had serviced their debt continually.

Argentina has emerged from its period as a defaulting debtor on 'the most advantageous terms ever secured by a middle-income country in debt restructuring history'. When by 2005, 76% of creditors accepted Argentina's aggressive negotiating stand, The Financial Times wrote, 'Argentina gambled, and the gamble paid off'.

financing, it is possible to imagine the poorest countries will continue to incur costs, rather than face the threat of reduced loans or investment from the more powerful creditor nations.

Second, the debt repayments of the poorest countries are part of a continuing vicious cycle of underdevelopment. An international arbitration mechanism could assist in discrete ways by bringing more accountability to the system of finance, and by limiting the ability of the Bretton Woods Institutions, in particular the IMF, to continue to enforce policies on poor countries which do not necessarily aid their development. But for successful development, a menu of deeper solutions will be required.

4.3. Obstacles and Opportunities

As the concerns raised in the previous section make clear, in the end, sovereign debt is political, and thus solutions to repayment problems that ignore the political context are unlikely to work. This conundrum makes the challenge of implementing a new framework to replace existing mechanisms for debt management a substantial one.

Despite the desirability of an international debt arbitration process, serious obstacles stand in the way of its establishment. Although some creditor countries may be prepared to set up some sort of sovereign insolvency regime, there is at present the strong likelihood that private banks, Northern countries, Southern elites and the international financial institutions will continue to resist it. After all, the status quo suits the creditors in a myriad of ways. This makes an agreement in the near future a major political challenge.

As Soren Ambrose says:

When the Northern countries that control the global economy decide to institute a truly “fair and transparent” arbitration system at its centre, the revolution (if you will) will have already occurred ... [therefore] political pressure will have to be mounted that gives the controlling powers little choice but to accept a new and just system for ordering the global economy.⁸²

Debt Audits and Repudiation

It is difficult to imagine how sufficient ‘political pressure’ could be mounted to challenge the dominant approach to sovereign debt management without a number of sovereign debtors opting to play the ‘default card’ by refusing to repay their debts until better terms have been negotiated. Still, a strong and aggressive approach by indebted countries towards their creditors might not only be in the interests of the nations’ citizens, but also the only way to get an international insolvency mechanism on the table. A more aggressive approach is highly justified. After all, the accumulation of unsustainable debts by much of the Global South has left a well-worn trail back to the institutions and actors in developed countries, as has been discussed already. In particular, the competitive trade policies of developed countries and the debt accumulation of less-developed countries are inherently linked.

Debt audits are now a key strategy for many governments and civil society groups in the Global South. Audits have been used to expose the culpability of both parties in the accumulation of bad debts, often demonstrating breaches of fiduciary duty, illegality and even criminality surrounding the loan contraction process. A comprehensive public audit in 2008 encouraged President Correa to default on some of Ecuador’s most unjust debt, eventually leading to a write-down by some of its creditors.⁸³ With the predicament now facing some countries in Europe, calls are being made for establishment of a public commission in Greece to examine the debts that lie at the root of the country’s crisis. Ordinary citizens, who are being made to bear the costs of EU rescue packages and tough austerity programmes, know little about the composition and terms of their mushrooming public debts. Campaigners say an Audit Commission is necessary to redress this fundamental failure of the democratic process.⁸⁴ Comprehensive audits thus provide valuable evidence that can strengthen the call for countries to repudiate.

⁸² Soren Ambrose, ‘Social Movements and the Politics of Debt Cancellation’, *The Chicago Journal of International Law*, Vol. 6, 2005, p. 284.

⁸³ See Comisión Para la Auditoría Integral del Crédito Público, Ecuador Debt Audit, available online: www.auditoriadeuda.org.ec.

⁸⁴ See Jubilee Debt Campaign, Campaigners call for Greek debt audit, 3 March 2011, available online: <http://www.jubileedebtcampaign.org.uk/?lid=6798&tmpl=jdcmprint>.

Conclusion

Since at least the early 1980s, less-developed countries in Asia, Africa and Latin America have seen recurring sovereign debt and financial crises disrupt their economies and cause suffering to their people.

These debt crises have been at least partly a result of irresponsible financing decisions by private and public actors in industrialised countries, although this role often goes unacknowledged. The dominant explanation for these crises in the Western world lays the blame at the feet of the indebted countries. The management of these crises is in the hands of the Bretton Woods Institutions, and the prevailing belief is that this arrangement is largely fair and equitable, with no significant reforms needed.

An examination of the facts challenges this understanding. Rather than being fair and equitable, the existing framework undermines debtor sovereignty and leads to unnecessary suffering. Moreover, it is blind to the continual pattern of impunity surrounding the poor financing decisions of creditors, and to the long list of policy errors perpetrated by the Bretton Woods Institutions on supplicant countries.

An international insolvency regime, along the lines of an independent arbitration mechanism, would give priority to governments' obligations to meet the essential needs of its citizens, introduce a modicum of accountability to financing decisions, and elevate debt renegotiation decisions to a neutral and legitimate forum. It would have the added benefit of downgrading the often harmful role played by the Bretton Woods Institutions.

An international insolvency regime would not be a panacea for inequity in the global economy, but it is an important first step. However welcome, it is unlikely to come about without governments in the Global South taking a stronger and more aggressive stand against their creditors. A more aggressive approach is highly justified. After all, the accumulation of unsustainable debts by much of the Global South has left a well-worn trail back to the institutions and actors in developed countries.

Wealthy countries believe that the current regime suits them. In particular, the financial sector fears that they will be penalised by a more comprehensive regime or framework and lobby constantly against change. But they are mistaken. In wealthy countries, the financial benefits of the current system serve to line the pockets of a select few. The historical record shows that significant changes have only been made when mass public and political pressure was placed on creditor organisations to take such steps. As responsible global citizens, we should speak up in support of change to a system that harms millions, if not billions, of lives in the Global South.

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