

An “Orderly and Fair Debt Workout Mechanism” –

An issue on the road to Doha

Between 1999 and 2005 substantial progress has been achieved in terms of debt relief for developing countries and emerging markets. Through a combination of partial debt relief and strong economic growth key indicators could be considerably reduced in several countries. In a few Non-HIPC countries individually designed debt relief also led to considerable improvements.

During this process the international community failed, however, to develop debt management as such any further. A newly over-indebted developing country would in principle face today the same problems countries had after the crisis’ outbreak in 1982: there exists no comprehensive mechanism to reduce a country’s exposure to all its creditors in an orderly and pre-defined way. Neither the highly indebted poor countries initiative (HIPC) nor the multilateral debt relief initiative (MDRI) relief, nor the World Bank’s debt sustainability analysis (DSA), which still relates only to the poorest countries and thus to the limited scope of creditors who traditionally lend to them, has changed this dilemma.

At the same time the spectrum of creditors and the variety of instruments these creditors use, has considerably widened in the past years. Transition and emerging economies have become important lenders themselves. So have private investment funds and domestic lenders. New instruments include new types of bonds, the return of the classic syndicated loan from the money centre banks, as well as a new run by Export Credit Agencies.

The International Financial Institutions (IFIs) have tried to bring lending decisions by the new creditors within the borrowing limits set under the Bank’s debt sustainability analysis (DSA). These efforts do not look promising, because they aim at unilaterally exerting pressure on the borrower, without providing much of an incentive for the creditor to forego an investment opportunity, which would eventually endanger the borrower’s long-term debt sustainability. In any event, the Bank does not calculate DSA guidelines for middle-income countries.

Individual instruments for dealing with workouts from debt crises, like Collective Action Clauses (CACs) in bond contracts or Codes of Conduct for debtor governments and creditor representatives can be useful at times. However, they generally refer to not more than one group of lending instruments or creditors when there are usually multiple types of lenders with claims on a crisis country.

Additionally debt workouts continue to be hampered by increased activities by old creditors as well as vulture funds, litigating against sovereigns, often contrary to debt relief decrees by the Multilateral Institutions or the informal government creditor cartel of the Paris Club.

This lack of coherence in sovereign debt management provides new relevance for proposals for impartial and coherent debt workout procedures. Some of these have already been intensively discussed during the Financing for Development process before and after Monterrey. These proposals include the IMF’s Sovereign Debt Restructuring Mechanism and also farther reaching proposals by academia, civil society and Southern official sectors. Most of these proposals share characteristics with a fair and transparent arbitration process.

Key elements of an orderly, effective and fair debt workout mechanism are:

- One single “insolvency” process needs to involve all creditors,
- Impartiality in decision making,
- Automatic stay on litigation to enforce loan contracts,
- Impartial assessment of a sovereign’s sustainable debt level and income exempt from debt servicing.

Recommendation: Multistakeholder consultations on an orderly, effective and fair debt workout mechanism should be revived in the framework of the Doha follow-up process. Concrete proposals on next steps should be worked out and reported to the High-Level Dialogue on Financing for Development in 2009, followed by international commitment to action embodied in a resolution of the General Assembly.