

Briefing note 3

Unfinished business on developing country debt

Debt meltdowns can strike individual countries with the force of an earthquake, sometimes setting off global financial shock waves. While one proposal for sovereign debt restructuring that could avoid these hazards has been shelved, a report of the UN Secretary-General is calling for a study group to come up with workable alternatives.

External borrowing is a natural part of the public and private financing of developing and transition economies – but it can be dangerous when done to excess. Recognizing the legitimate need for “sustainable” borrowing, the 2002 International Conference on Financing for Development warned that excessive debt loads could easily turn into debt crises under the weight of deteriorating economic conditions. Its Monterrey Consensus contains a strong endorsement by a major global meeting for a new consideration of international approaches to orderly debt workouts.

The rationale adopted in Monterrey was that the international community needs policies both to help countries avoid debt crises as well as to work out from the crises that do occur. Debt workouts should take place in an orderly, speedy and effective manner and, crucially, provide for fair burden sharing between public and private sectors as well as among debtors, creditors and investors. Most informed observers recognize that Argentina’s protracted workout from international default since 2001 is a clear indication that the international community does not yet have such a mechanism available. Of equal concern is the painfully slow debt reduction process for very poor countries under the HIPC Initiative (see next page).

Balancing the burden of debt restructuring

Currently, governments in debt crisis seek relief from the Paris Club of government creditors for debts owed to governments, and from informal “London Clubs” of banks for bank debt. Restructuring of defaulted international bonds has been an even more difficult process that has been handled in *ad hoc* ways.

One problem with defaults on international bonds is that there is a large and diverse group of bondholders, who are likely to have widely varying ideas on the terms of restructuring. There currently exists no mechanism to mediate or arbitrate agreement among these creditors on how far they will go in relinquishing bond repayment.

Another obstacle to overcome is the difference of interests between creditors and debtor. While the lenders may wish to insist on being repaid in full, as per contractual agreement, the government of the country in crisis often feels it must meet basic economic and social needs of its citizens, who have been traumatized by domestic financial crisis, before making full repayment.

Shortly after the 2002 summit on Financing for Development (FfD), the International Monetary Fund investigated the idea of a comprehensive, statutory approach to restructuring the external debt of governments. The proposal for a “Sovereign Debt Restructuring Mechanism” (SDRM), gained considerable attention in finance circles, but did not win broad backing. Among other factors, some opponents objected that the IMF itself would likely be a creditor of a government in debt crisis, and would not be suited to act as a neutral coordinator.

Instead, a more limited proposal has found favour. The principle is that “collective action clauses” would be included in contracts for newly issued bonds, setting out procedures by which these bonds would be restructured in the event of default.

If such clauses become widespread, bond restructuring would likely be less of an *ad hoc* affair. But there would still be no mechanism to make relief from different categories of debt – held by banks, governments, multilateral agencies or private lenders – comparable, or guarantee that sufficient relief is available overall to help the country reach a sustainable debt situation.

In deciding not to consider adoption of the SDRM, the IMF's International Monetary and Financial Committee nevertheless recognized that the proposal had raised issues relevant to the orderly resolution of debt crises. Indeed, the staff of the Fund continues to study the issue, and in a recent official report acknowledged that innovations such as an independent mediation service could prove useful to a country in crisis with many classes of creditors.

Moreover, the Intergovernmental Group of 24 on International Monetary Affairs stressed at the annual meeting of the Bretton Woods institutions in September 2003 that proposals circulating for a voluntary code of conduct on debt restructuring should be agreed by sovereign issuers of bonds as well as by private creditors.

The report of the UN Secretary-General on follow-up to the Monterrey summit concludes that consideration of international approaches to orderly debt workouts remains "unfinished business", and that further multi-stakeholder exploration of feasible options is warranted. It calls for an open and informal expert study group on debt and its development dimensions, organized within the framework of the FfD process. Such a study group would develop outlines of proposals that might gain broad support for a comprehensive, coherent and fair debt workout mechanism, as an integral part of the international strategy for financial crisis prevention and resolution.

The slow-moving HIPC Initiative

For the poorest of debt-ridden countries, an international framework has been in place since 1996.

The heavily indebted poor countries (HIPC) Initiative sets out a complex, multiyear process for qualifying countries in crisis. Out of some 40 countries initially targeted, only eight have reached the "completion point", although 18 additional countries reached an intermediate benchmark called the "decision point" by June 2003 (and one more in July).

The Secretary-General's report, which is being considered at a 29-30 October High-Level Dialogue of the UN General Assembly, finds that some of the eight "completion point" countries are in fact experiencing worsening debt indicators. A good part of the problem can be traced to lower export receipts in a world economy that, in the early twenty-first century, has been weaker than anticipated when their debt relief was programmed. Official donors and creditors can "top up" their relief in such cases, although they have done so thus far only for one country.

Slow progress through the HIPC process has been blamed on difficulties the indebted countries have had in following the macroeconomic and structural reform programmes and in preparing required Poverty Reduction Strategy Papers. In the view of the Secretary-General, these disappointments not only reflect the weak international economy of recent years, but also raise questions about whether initial expectations were unrealistic in regard to economic growth and the extent of feasible policy reform.

Moreover, there have been long delays in raising the required financial resources for the HIPC Trust Fund, from which relief of multilateral institution debt obligations are paid. In addition, some creditors have not accorded all the agreed relief.

The Secretary-General thus calls for accelerating and deepening the HIPC process through additional donor contributions and relief. Also noted is the lesson that the persistence and reacceleration of debt in the "completion point" countries indicates that new external financing should be mainly in non-debt creating forms. This means attracting greater foreign direct investment, and should also entail a significant shift in official flows from loans to grants for poor countries.

* IMF, "Reviewing the process for sovereign debt restructuring within the existing legal framework," 1 August 2003.