

Sovereign debt restructuring and the right to development: Challenges from an incomplete framework

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Abstract: *The article reviews the link between human rights and foreign debt, by highlighting the validity of the right to development, as stated and confirmed by different declarations made by international organisations in the last three decades. The right to development is understood as a human right. The lack of proper institutions to deal with debt problems and crises has in the past been hard on emerging countries, halting growth and retarding development in the affected countries and societies, as clearly exemplified by the Latin American debt crisis of the 1980s. It is contended that creating proper institutions to deal with debt issues at the international level will help resolve these crises and will contribute to the continued realisation of human rights.*

Key words: *debt; development; human rights; institutions; Latin America*

1 Worlds apart come together: Foreign debt and human rights

At first glance, foreign debt and human rights may appear to belong to two separate and unrelated fields of study. After World War II, when the question of human rights emerged, scholars and practitioners were reluctant to embrace these two subjects as a single academic pursuit. Some pioneering and isolated efforts were carried out in the mid-1970s, but the trend lagged until the mid-1990s. During the last two decades, however, many have started to explore the wide range of connections between foreign debt and human rights. The intersection between these areas appears as soon as one extends the scope of consideration beyond the contractual duties that exist between a debtor state and its creditors, and a more comprehensive and holistic approach takes shape, considering other effects of over-indebtedness on economic and socially-relevant aspects. In fact, a debt overhang or a high debt trap – the prolonged situation where an unresolved debt problem restrains growth – may result (as has in the past been the case in numerous countries) in the undermining of human rights.

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The connection between debt and human rights is certainly not novel but, during the 1970s, its significance was either neglected or simply ignored.¹ The first wave of financial globalisation in the post-war era was contemporaneous to numerous authoritarian regimes in Latin America. It was fostered by highly-liquid financial markets in the United States and Europe, after the recycling of dollar reserves by oil export countries, which were in turn favoured by increases in the oil price as a result of the oil crises of 1973 and 1979. International banks with aggressive lending policies found in Latin American economies – constantly lacking capital – prospective customers willing to take all funds offered, especially in the region's southern cone. The process – which also involved some economies in other regions of the world – forced many developing countries in Latin America into a position of intense indebtedness. The fact that the region was ruled mostly by unelected military rulers who violated the most basic human rights was certainly not an obstacle for lenders to carry on their business as usual.

The connection between debt and human rights also went unnoticed during the 1980s, when countries regained democracy and struggled with unsustainable debt burdens that delayed their development processes for around a decade (the 'lost decade for development', as it was later labelled by the United Nations (UN) Economic Commission for Latin America and the Caribbean). International financial institutions, fully involved in the long and arduous, yet unsuccessful renegotiation process, completely disregarded any consideration of the impact of adjustment programmes on the enjoyment of human rights, and promoted structural reforms and stabilisation policies which even further affected the social situation.

More recently, however, several studies have begun to focus on the connection between debt and human rights. Some have examined the origin of debt and questioned the legitimacy of debt incurred by non-democratic governments. As stated earlier, indebtedness in Latin America grew substantially during the rule of autocratic governments and dictatorships. The current UN Independent Expert on Foreign Debt and Human Rights has even introduced the concept of 'financial complicity' with reference to the lending to states involved in gross human rights violations. Indeed, the UN expert, Mr Bohoslavsky, has argued that '[f]oreign financial assistance might prolong the life of regimes engaged in severe, large-scale violations of human rights' (Bohoslavsky & Cernic 2014). Such characterisation of the past is indeed a lesson for the future. However, despite this international recognition, there was no compensation for societies that suffered through such processes.

During the 1980s, the continuous over-indebtedness in developing economies had wide effects. The debt problem – represented by high debt stocks and protracted debt-servicing difficulties, together with rationed foreign credit – conditioned and determined the prevailing economic policies of highly-indebted countries. It severely restrained policy space and narrowed the range of policy options available to governments, including many newly-elected democratic authorities in Latin America. The debt issue undermined the long-standing national development

1 One exception may be the 'Study on the impact of foreign economic aid and assistance on respect for human rights in Chile' prepared for the UN's Sub-Commission on Human Rights by Cassese in 1979.

strategies of affected countries and weakened the enforcement of the human rights of their citizens.

Since the end of the 1980s, many researchers have thoroughly reviewed the links between debt, its effects on economic policy and human rights. Özden, for example, makes a detailed assessment of how foreign debt and the subsequent IMF-supported adjustment programmes implemented in the mid-1980s through the early 1990s have caused or aggravated human rights violations among the affected nations (Özden 2007). According to this author, the list of these rights is long and impressive. It includes the right to self-determination; various economic, social and cultural rights; the right to live in a healthy environment; and other civil and political rights. It even goes as far as including the introduction of legislation restraining basic freedoms that result in the repression of organised labour in some less-developed countries. However, serious and relevant as they are, both at individual and social levels, we will narrow our analysis to focus on the impact of excessive debt service burdens on a single right, the right to development, recently recognised as such by international human rights organisations.

The rest of the article is organised as follows: After the introduction, section 2 examines the concept of development and the interaction with human rights. Section 3 reviews the Latin American experience in the 1980s, with special emphasis on the macro-economy of the largest regional debtors of that time, Argentina, Brazil, Chile and Mexico, highlighting the similarities and differences. Section 4 deals with the concept of debt overhang, and section 5 presents the successive attempts to introduce innovations in the restructuring mechanisms to deal with sovereign debt problems. The final section presents the conclusions.

2 Rescuing development as a human right

The Declaration on the Right to Development, adopted by the UN General Assembly, almost 30 years ago, in mid-1986,² at the same time that Latin America was suffering from a debt crisis which inhibited its development for almost a decade, states as follows:

The right to development is an inalienable human right by virtue of which every human person and all peoples are entitled to participate in, contribute to, and enjoy economic, social, cultural and political development, in which all human rights and fundamental freedoms can be fully realised.

It was at this plenary meeting that consensus was reached on the fact that the right to development belongs to the set of human rights.

As Villaroman points out: 'As originally envisaged, the right to development is not a human right which is claimable by individuals against their own state, but a people's right' (Villaroman 2011). It is, therefore, a collective right, and not an individual right affirmed and stressed by international instruments.³ Collective rights cannot legally be

2 Resolution 41/128, art 1, para 1, available at <http://www.un.org/documents/ga/res/41/a41r128.htm>.

3 The UN declaration alludes that the right to development is dual in its nature and both a collective and an individual right.

asserted by an individual. Also, Sanders reminds us that collective rights have not achieved the level of acceptance and recognition usually rendered by individual rights (Sanders 1991). Collective rights frequently involved promises that were not upheld. However, far from being disregarded as a transient trend, the concept of the 'right to development' evolved and maintained issues related to development in the international agenda. In fact, the 1986 Declaration was later recognised and endorsed in significant world conferences, and it was reaffirmed by the Vienna Declaration (1993), the Millennium Declaration (2000) and the Monterrey Consensus (2002).

Since its inception, the right to development has been challenged from many different perspectives, not only regarding the span and scope embodied in the concept but also with reference to the legal obligations that such a right – if enforced – would entail. Furthermore, diverging standpoints on this matter among developed and emerging countries turned discussions in international fora around the practical implications of the right to development into highly-politicised debates. But where do we stand at this point? Our own stance is in agreement with Kirchmeier: The exercise and enjoyment of the right to development presupposes compliance with more basic rights contained in the International Bill of Rights (Kirchmeier 2006).⁴ In this context, the right to development requires an additional component: an enabling environment which should be conducive to the realisation of such a right. The responsibility for creating and maintaining such an environment belongs to both the state and the international community. Throughout this article, we emphasise the lack of international institutions to deal with debt issues as a major problem and as a serious global obstacle to the right to development. In the past, the failure to address this issue had an adverse effect on the growth of highly-indebted countries, and retarded development in Latin America for about a decade.

Nevertheless, the concept of the right to development lacked a more precise definition. What is meant by 'development'? What does this right really entail? What is its precise content? Where can it be claimed, or is it merely declaratory? It is this lack of precision that grounded reservations by academics and practitioners. Scholars and officials, especially from international organisations and development agencies, attempted to fill in the gap in order to overcome the threat of skepticism raised by its critics. An expert, the late Arjun Sengupta, for example, in numerous papers highlighted the right to development as a human right. He described it twofold as (Sengupta et al 2005: 67):

- (a) a particular process of economic, social, cultural and political development, in which all human rights and fundamental freedoms can be fully realised;
- (b) ... a human right by virtue of which every human person and all peoples are entitled to participate in, contribute to and enjoy that particular process of development.

Some scholars have elaborated on the idea of development, expanding its definition from the narrow economic characterisations previously used.

4 The Universal Declaration of Human Rights, the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights.

Understanding development as a mere increase in national output or a surge in the material resources of a country are now considered outmoded and inadequate. Prof Amartya Sen, a winner of the Nobel Memorial Prize for Economics, for instance, has advocated that development should be understood as the 'expansion of the real freedoms that people enjoy' (Sen 1999), adopting a perspective that undoubtedly coupled the goal of development with the improvement in the human condition. He also advocated that development required the removal of major sources of non-freedom, including poor economic opportunities. Furthermore, he defined the right to development as 'a conglomeration of a collection of claims, varying from basic education, health care and nutrition to political liberties, religious freedoms and civil rights for all' (Andreassen & Mars 2007).

The process of development and the realisation of human rights are thus intrinsically connected (Buckley 2009). The road to development faces multiple obstacles of a diverse nature. Heavy debt burdens are certainly a major obstacle, especially when refinancing terms are unattainable and servicing conditions become insurmountable. Furthermore, as will be emphasised in this article, there is a clear lack of institutions that can deal with debt crises, such as an international lender of last resort or a widely-recognised framework for an orderly restructuring of sovereign debts in distress. Thus, debt crises disrupt growth processes and negatively affect the right to development. As mentioned earlier, in Sen's view the crisis reduces freedom, and in Sengupta's view it directly hampers the pursuit and enforcement of human rights.

In the last two decades, the issue of foreign debt and human rights has also been addressed by international organs with explicit mandates and competence in the promotion and protection of human rights. In 1998, the UN Human Rights Commission (which would in 2006 be replaced by the UN Human Rights Council) appointed a Special Rapporteur on the Effects of Foreign Debt on the Full Enjoyment of Economic, Social and Cultural Rights.⁵ In 2004 the Commission requested the expert to draft general guidelines to be followed by states and by private and public, national and international financial institutions in decision making and the execution of debt repayments and structural reform programmes, including those arising from foreign debt relief, to ensure that compliance with the commitments derived from foreign debt will not undermine the obligations regarding the realisation of fundamental economic, social and cultural rights, as provided for in the international human rights instruments' (Resolution 2004/18). In 2012, after a long delay, discordant debates and numerous consultations, the UN Human Rights Council adopted the Guiding Principles on Foreign Debt and Human Rights (Guiding Principles 2012).

The adoption of the Guiding Principles constituted an important step forward in the recognition of the impact of debt on human rights. However, a more comprehensive effort is still needed in order to institutionalise a restructuring framework. The 2012 Guidelines

5 The Special Rapporteur was later renamed 'Independent Expert on the Effects of Foreign Debt and other Related International Financial Obligations of States on the Full Enjoyment of all Human Rights, Particularly Economic, Social and Cultural Rights'.

acknowledge that previous official initiatives failed to deliver a sustainable framework, affecting the development perspectives of highly-indebted economies. It reminded member states of their human rights obligations in the context of external debt negotiations. It stressed that the economic, social and cultural rights of the most vulnerable sectors of society should not be undermined under any restructuring arrangement. In line with our research, the report of the Independent Expert enumerates the declarations, resolutions and decisions of major UN conferences that have confirmed the link between debt, human rights and development (Lumina 2011: 5). However, it is still too early to measure the impact, if any, of these Guidelines on the international lending and debt restructuring practices in the medium and long term.

In the meantime, countries affected by sovereign debt issues, notably Argentina and Greece, still contend with the fact that there is no institutional framework or legal mechanism to resolve this problem quickly and systematically. Greece appears to be in a deadlock. Having defaulted in 2001-2002, Argentina restructured the majority (but not all) of its outstanding liabilities with private creditors in 2005-2010. It is still dealing with unsettled disputes before US courts with speculative hedge funds, and facing law suits from hold-out investors in other jurisdictions.

3 Latin America's debt crises: Lessons unlearned

Developed and emerging markets have in recent history experienced numerous debt crises. Taking a historical perspective, Reinhart and Rogoff compile all known episodes from the early financial history of the Middle Ages to more current events, such as the US financial crisis that followed the implosion of the housing bubble in 2007, and the still unresolved sovereign debt crisis that has affected the periphery of the European Union (EU) (Reinhart & Rogoff 2009). At the time of writing, the Greek debt problem was still unresolved. It has not been properly addressed in a reliable and timely manner. The approach implemented under the auspices of the International Monetary Fund (IMF) and European institutions has allowed the country to replace its private creditors by official creditors, simply exchanging one type of debt for another. However, this has not reduced the unsustainability of the debt, which has now reached the intolerable level of nearly 180 per cent of its gross domestic product (GDP). Such a debt level is inconsistent with the flow of income produced by the economy, and the country has now registered 24 consecutive quarters of constant decline. The engagement of indebted European economies to aggressive austerity programmes has placed these countries on the verge of their very own 'lost decade', and reveals that important lessons from major past events, such as the Great Depression or the Latin America debt crisis, still remain unlearned.

Latin American countries frequently appear among the catalogue of financial crises of the post-war era. Between the mid-1950s and the mid-1960s, countries in the region suffered from frequent balance-of-payment crises associated with stop-and-go cycles that characterised their economic evolution during that period. Expansions were concomitant with the accumulation of successive current account deficits. The external imbalance was later corrected by stabilisation policies based on strong exchange rate depreciations and contractionary demand policies that

compressed economic activity and imports. With the following expansion, the cycle tended to repeat itself. During those decades, funding for Latin America was unavailable in the voluntary international capital markets.

This state of affairs changed in the 1970s after the first oil shock in 1973 paved the way for high liquidity petrodollar recycling. Incentives for indebtedness developed from a combination of highly-liquid international contexts and aggressive bank lending policies by American and European institutions. Latin American countries, especially those in the Southern Cone, followed debt-prone (and unsustainable) macro-economic programmes. These programmes essentially combined the openness of the capital account and some sort of fixed exchange rate arrangement that appreciated the real exchange rate.

It must be stressed that not all debt was originally incurred by the public sector. In many instances, the non-financial corporate sector was a relevant actor in the process. However, once the crisis had been triggered, the private sector pushed to socialize, at least partially, its own liabilities. During the 1980s in Argentina, Chile and Mexico, important transfers were observed through different mechanisms, and contributed in this way to increasing the sovereign debt.

In the late 1970s and early 1980s, the macro-dynamics were upset by successive negative external shocks: the rise in international interest rates in 1979 and the decline in the terms of trade. Such shocks deeply affected both the balance of payments and the fiscal accounts. Prior to 1979, borrowings by Latin American countries were associated with financing the deficit in foreign trade. Gradually, under new financial conditions, new external obligations were increasingly directed towards covering the payment of interest from previously-contracted financial liabilities.

Furthermore, after Mexico's default in August 1982, voluntary credit to the region became highly rationed. It was no longer possible to finance those imbalances using external funding. In turn, those marked imbalances in the external and fiscal accounts eroded the stability and growth potential of the affected countries. Latin American economies were forced into drastic adjustment processes based on massive devaluations and reduction in public expenditures. The continuity of state-led import substitution industrialisation (ISI) growth strategies, which had been implemented throughout the region from the mid-1950s, ended.

We will not detail the events of that period here. In fact, several narratives and analyses exist about the economic process that slowly evolved with the implosion of the debt crisis until growth was eventually resumed after major delays (Ocampo 2014). However, by taking such a historical experience from today's perspective, we can extend our objective to draw some potentially-useful lessons, especially regarding the lack of an international lender of last resort and a sovereign debt restructuring mechanism.

Once the crisis had been triggered and countries became credit-rationed in voluntary capital markets, they engaged in policies aimed at generating significant external surpluses in order to perform their debt obligations. The debt then became the economic policy's primary concern, at the expense of all other policy objectives, including the obligation of states to provide minimum essential levels for each economic, social and cultural

right. As was recognised by the UN expert in the field, in a country with limited resources, debt repayments compete with much-needed public expenditures for social services, including education, health and housing, worsening access to basic public services and, thus, reducing the economic, social and cultural rights of their citizens.

The scope and persistence of the above-mentioned imbalances over time must be stressed if we wish to find a clearer picture of that period. A persistent imbalance may operate through price mechanisms and financial relations, affecting the economic structure and leading to additional imbalances. In fact, inflation may affect tax revenues, or speed up a demonetisation process of the economy, making even small fiscal deficits – under external credit rationing – difficult to finance. This is a situation which differs from transitory imbalances that may be met with traditional stabilisation policies. Persistent imbalances may affect growth capacity, as they induce changes in the structure of the economy and agents' decisions on savings and investments.

Indeed, one of the basic problems in the 1980s was the incorrect assessment both local authorities and international financial institutions made regarding the severity of new imbalances. At first, imbalances were addressed with traditional stabilisation tools. However, these kinds of adjustment programmes, which provided insufficient credit support, were better suited to tackling liquidity problems and not major gaps in the external and fiscal accounts. The prescription of the IMF and other institutions was later transformed to promote structural reforms in line with the Washington Consensus. Initiatives, such as the Brady Plan and the change in the prevailing conditions in international capital markets, provided greater access to credit. However, by the time this occurred, macro-economic instability, a shortage in external financing and weak national savings rates had already acted, halting growth and damaging the existing economic structure. In fact, most Latin American countries were only then able to resume growth (albeit modestly, in most cases).

The debt crisis of the 1980s halted growth for almost seven years. Growth was resumed only after some favourable changes in the international context and some sort of debt restructuring programme relieved, at least partially, the debt burden. Unfortunately, Argentina yet again repeated the debt cycle in the following decade. It underwent a severe macro-economic and financial crisis and defaulted once more at the turn of the century. Economist Ocampo calls the debt crisis the most traumatic economic event in Latin America's economic history. During the 'lost decade' it generated, the region's *per capita* GDP experienced a drop of nearly 8 per cent, poverty increased, and the already-widening gap between the rich and the poor further widened (Bértola & Ocampo 2012).

So far we have described the stylised facts of the process shared by the region. While these experiences share a common pattern, there are also some differences between the various cases. An in-depth analysis of the macro-economic particularities of the evolution of the different countries involved should take into account (a) each country's degree of indebtedness at the beginning of the period; (b) the changes in the terms of trade; (c) the relative amount of external assistance from international organisations perceived throughout the adjustment process; (d) the degree of success of the policies implemented to promote exports (or replace imports), including the exchange rate policy; and (e) the introduction (or

not) of some sort of debt-restructuring mechanism. Damill et al follow that line of research for Argentina, Brazil, Chile and Mexico (Damill et al 2014 and 2015).

4 The debt overhang problem

When an emerging country faces a large debt burden and market participants question its ability to repay, its access to international capital markets is greatly restrained and the country cannot take on any further debt to finance expenses or future projects. From here on, it must live with a debt overhang problem. Even if the overhang is revealed suddenly, it is the result of a long and persistent course. It is, indeed, a legacy from both the large capital inflows that fuelled the indebtedness process and from the sudden end to those flows. The latter factor is obviously very disruptive to the economy.

Debt overhang inhibits investment, both from the public and the private sector, through different channels, as is explained below. Debt then becomes a significant factor negatively affecting growth. The debt burden (and the inability to access the market in order to refinance financial obligations) inhibits growth. As Reinhart and Rogoff note, once the public (or private) debt overhang emerges, countries with a slower growth will take longer to escape from this (Reinhart & Rogoff 2012). Investment will not improve until the uncertainty caused by the debt overhang problem is, at least partially, erased or mitigated. Both the Latin American debt crisis of the 1980s and the problems currently faced by the European periphery perfectly illustrate this position: Removing the overhang, that is, aligning the debt obligations with the debtors' ability to pay, is a long and complicated process, because of the numerous actors involved and the lack of a proper institution to deal with the problem.

In this unfavourable environment, at least two connecting channels link public debt and economic growth. Given the fact that the government finds itself unable to borrow from international capital markets, it turns to domestic markets for funds. However, financial domestic markets of emerging economies are usually small and underdeveloped and lack sufficient depth to meet the funding required by the government (as was the case in many Latin American countries in the 1980s). The public sector would end up absorbing all available investment funds and would tend to crowd out private investment. If, instead, the government imposes higher taxes to finance its heavy financial obligation, the other classic debt overhang arises: Investments are discouraged because there is a risk that profits will be taxed heavily in this kind of situation.

As stated earlier, eradicating the debt overhang is difficult. It requires the reduction of the debt burden accumulated in the past and the debtor country should be allowed to re-enter the financial circuit. It is always tempting to favour a faster growth route in order to reduce the real burden of debt, but such an option, while desirable, is not a generally agreed available policy choice. A second option is debt restructuring (or, as it is now known in IMF jargon, reprofiling). The need for restructuring must be acknowledged by the different parties. No lender would voluntarily allow large nominal debt write-offs in order to bring down debt overhangs. As the Latin American experience of the 1980s shows (a history now

repeated in the case of Greece), a successive round of negotiations that does not include some sort of debt restructuring is unlikely to succeed. Debt must be dealt with in a definitive and timely manner, despite resistance of creditors to suffering losses. Financial obligations must be aligned with debtors' ability to service the debt. Bretton Woods institutions have not been helpful in that respect. Based on traditional moral hazard concerns, they have constantly refused to act as international lender of last resort,⁶ or as a bulwark for indebted countries seeking protection from creditors. This renders desirable a new and stable institution to level the path.

5 Institutions for a more efficient restructuring

There is one aspect where sovereign debt restructuring does not differ significantly from the treatment of other important global issues, such as climate change or the eventual threat from future pandemics, receive in international arena. The world's existing institutions still have trouble dealing comprehensively with particular kinds of problems and have failed to provide lasting solutions. No mechanism or framework for debt restructuring was introduced at Bretton Woods in 1944 or later by the two institutions created at that international conference for post-war economic management.

As was clear from the Latin American experience of the 1980s, the lack of a proper channel to tackle sovereign debt issues delayed the resolution of the crisis, harming both debtor nations and creditor banks. Individual negotiations between debtor countries and creditor banks (even with the participation of international financial institutions) proved to be drawn out and uncertain. The economic prospects of indebted countries did not improve and creditors' claims lost value in secondary markets. *Ad hoc* individual negotiations did not compensate for the absence of an institutionalised mechanism for the treatment of debt. Instead, they exhibited numerous shortcomings.

It took seven years to break the Latin American deadlock. When the Brady Plan finally recognised that debt could not be served at face value, it proposed a 'too little, too late' debt relief scheme. Despite some initial reluctance, banks were forced to participate. After its implementation, capital markets were reopened for the affected countries and growth could be resumed, albeit at a slow pace.

A slightly modified scenario has in recent years recurred. As already mentioned, Argentina once again defaulted on its liabilities to private creditors in late 2001 following the collapse of the macro-economic regime that predominated in the country during the 1990s. In 2005 (and again in 2010), Argentina offered an exchange for defaulted debt with large reductions. The vast majority of creditors (both domestic and foreign) accepted such offers. However, the exchange failed to deliver final closure to the debt issue. Argentina is still involved in litigation before US courts, as well as in other jurisdictions, with holdout creditors who have refused

6 There are a few exceptions to this rule, for example, the assistance package Mexico received from the IMF after the Tequila crisis.

to accept Argentina's restructuring offers. Current holdouts represent only a minor proportion of the debt defaulted in 2001 and 2002.

In 2014, the US Supreme Court turned down the consideration of a case, thus confirming the ruling of lower courts validating an odd legal interpretation of the *pari passu* clause – included in the original bonds – that not only favoured the plaintiffs, but also obstructed payments from Argentina to creditors who had accepted the restructured bonds. As Stiglitz and others have observed (Stiglitz 2014), such interpretation (now confirmed) has a negative long-term consequence: It creates incentives for non-participation by creditors in any future debt restructuring process. The judicial recognition of the right to interfere with payments to restructured creditors will hinder any future debt restructuring process for any sovereign borrower facing solvency issues.

The unresolved Argentinian situation illustrates, in our view, the unfortunate standing of sovereign debt restructuring today and confirms the need for remedies. The Euro crisis has also triggered a rapid increase in proposals in this area from diverse groups, including development experts and human rights non-governmental organisations (NGOs). Target 15 of the internationally-established framework Millennium Development Goals (MDGs) aimed at 'dealing comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term'. Still, despite the time and effort of different fora to reach consensus, sovereign debt appears to have little influence on the political agendas of high-level international bodies, such as the G-20. No applicable law exists and there is always a legal loophole for speculative hedge funds.

The rest of this section reviews different initiatives that have contributed, to varying degrees, to the debate about establishing some sort of framework for an orderly restructuring of sovereign debt in distress. As stated above, during the last few years, there has been a 'one-step-forward and two-steps-back' kind of progress regarding this issue. Each initiative signified a move forward, but not enough to produce a policy shift. We have not been short of ideas, but of progress. As a result, an international legal framework that would facilitate an orderly, timely and speedy debt restructuring process still does not exist.

5.1 Proposals by human rights organisations and development-oriented experts

A few proposals have been put forward by different sectors of civil society. All seem to follow Raffer's assertion that '[s]afeguarding human rights makes it necessary that such arbitration mechanism includes some form of debtor protection' (Raffer (undated)). Among these initiatives is Raffer's widely-discussed proposal, as well as the following ideas developed by Paulus and Kargman (2008):

- Raffer suggests extending procedures from the US Insolvency Code to sovereign debtors. Taking into account that countries cannot be put under receivership, as that would contradict sovereignty and democracy, his scheme emulates chapter 9 of the Law, which regulates the insolvency of US municipalities, rather than chapter 11, which is generally applied for corporate insolvency. Raffer's initiative favours substituting the usual insolvency judge with an *ad hoc* arbitration panel with the agreement of affected parties, instead of introducing a new international legal

institution. Hence, the process becomes an arbitration process that follows predefined rules and principles. It would provide bankruptcy protection and would be binding for all creditors. According to Raffer, the procedure would also open the process for the broad participation of civil society and would foster the affected parties' 'right to be heard'.⁷

- In contrast, the Paulus and Kargman initiative consists of establishing a sovereign debt tribunal under the auspices of the United Nations with the creation of an Insolvency Chamber in the International Court of Justice.

5.2 Proposal by the International Monetary Fund

In 2003 the IMF proposed a twofold procedure for adjudicating sovereign debts. On the one hand, it promoted a contractual approach based on collective action clauses (see below); on the other, it favoured the adoption of a statutory approach, titled the Sovereign Debt Restructuring Mechanism (SDRM), which would have established a separate entity to facilitate the restructuring process.

SDRM would have consisted of an independent bankruptcy forum, created by an amendment to the articles of agreement that originated from and rules the IMF. Such a forum would have been vested with the jurisdiction to facilitate the restructuring process and would have been binding on all its members.

The bankruptcy forum would have established a bankruptcy system derived from insolvency law. There were three particularities to the proposed system. First, the debtor could, upon request, secure a stay on all creditor claims. Second, the creditors would have the power to extend the length of the stay should extra time be needed to break an impasse. Third, creditors would be encouraged to subordinate their outstanding claims to any new loans in order to encourage fresh lending.

The initiative lacked the necessary political acceptance. As Rogoff described, the proposal faced sharp opposition not only from creditors who feared that the IMF would be too friendly to problem debtors, but also from emerging markets that foresaw no near-term risk to their perceived creditworthiness (Rogoff 2012). Healthy borrowers were concerned that creditors would demand higher rates if the penalties for default were relaxed.

5.3 Innovation in contractual technology: Collective action clauses

A valuable (but limited) instrument consisted of introducing collective action clauses (CACs) in bond contracts. CACs made it possible to amend contract terms if a majority of holders agree to a new term for that particular commercial paper. The purpose of these clauses is to reduce the incentive for individual creditors to hold out and not to participate in a restructuring process in the hope that they are paid in full agreement with the original terms of the debt contract. In recent years, the use of CACs in sovereign bonds has become much more common.

Partly as a reaction to the Argentinian and Greek cases (discussed above), the International Capital Market Association (ICMA) has

7 In the same vein as Raffer, but with a more private orientation, Richard Gitlin and Brett House (2012) outlined a 'non-statutory, non-institutional, un-codified sovereign debt forum' as a venue for debtors and creditors to negotiate.

published, revised and updated the recommended text for collective action clauses to include the terms and conditions of sovereign debt securities. The use of these new terms in sovereign notes is intended to facilitate future sovereign debt restructuring and avoid the flaws raised by such cases.

Under the new standard model of CACs, the issuer can – as always – ask the holder of each bond series to change the prevailing terms. (If three-quarters of the holders of a particular bond series agreed to the new terms, it would be binding on the remaining minority.) The issuer would now be able to survey the holders of multiple series all at once. If at least half of each series and two-thirds of all outstanding debt agreed to the new terms, the remaining creditors would be bound. Finally, the issuer could interrogate holders of multiple series at once but take only a single vote across all affected series. If three-quarters of the total approved the new terms, the remainder would be bound. That is, the agreement would bind all holders, regardless of whether they voted in favour of or against the new terms. Consequently, dissenting holders would be barred from taking private actions to court. Greece used a similar procedure to restructure its domestic debt.

The widespread inclusion of new CAC terms is a step in the right direction and significantly mitigates the problem. However, they have been oversold in the financial media. There are still limitations on the generalised use of CACs: They do not provide for co-ordination across asset holders (for example, bondholders versus syndicated loans claims) as would a comprehensive framework. They only cover a certain segment of the external debt and do not solve over-indebtedness problems (Galpern 2014).

On 9 September 2014, the UN General Assembly approved Resolution 63/304 which supported a new bankruptcy process for sovereign debt restructuring and set up an *ad hoc* committee to draft a proposal. A year later, the Assembly fully endorsed the report elaborated by this committee and adopted a resolution unfolding nine Basic Principles on Sovereign Debt Restructuring Processes intended to guide future debt restructuring processes.⁸ Certainly, the resolution does not go as far as proposing a definitive legal multilateral framework, but lists the principles of sovereignty, good faith, transparency, impartiality, equitable treatment, sovereign immunity, legitimacy, sustainability and majority restructuring as the pillars that should guide these kinds of processes. While all seem to be both important and subject to further interpretation, the principle of majority restructuring has to be highlighted. The long Argentinian saga against speculative hedge funds before US courts – including the US Supreme Court – provides a startling reminder of how certain groups representing a minority of the creditors can completely disrupt a restructuring process agreed to by 92 per cent of creditors. Furthermore, they may also harm the interests of third parties, such as those of creditors that initially agreed to restructuring proposals or financial institutions that operate as intermediaries in the process. It is important to stress that, unlike the Security Council, resolutions adopted by the UN General Assembly are legally non-binding. They do carry political weight, but do

8 http://www.un.org/en/ga/search/view_doc.asp?symbol=A/RES/69/319 (last visited 30 June 2015).

not trigger further consequences. This point is significant here: Although the vote was overwhelmingly in favour of the resolution, it was rejected by, among other states, the US, Japan, Germany and the UK, while the remaining European Union members abstained. The fact that neither the US nor the UK is willing to admit these kinds of guidelines downplays the importance of the resolution. New York and London are the centres of international capital markets and any disagreement between creditors and debtors still has to be settled in the legal jurisdiction of those countries. Progress in this line of work still needs to be seen.

6 Conclusion

The prudent use of loan funds and effective debt management can effectively contribute to a country's development. In economic policy, prudence has to rule over the tendency of excessive loan taking by debtors and aggressive lending policies undertaken by creditors in liquid markets. As there are no institutionalised mechanisms to deal with sovereign over-indebtedness, debt negotiations are excessively lengthy: They prolong economic crises and their outcome is uncertain. Experience shows that, under the prevailing non-system, by the time an agreement has finally been reached, both debtors and creditors have accumulated great losses. There is a problem of co-ordination among creditors, leading to the existence of holdout agents. Thus, an international debt workout mechanism, which is absent in the current international financial architecture, must be created.

Different approaches have been proposed to establish such mechanisms, but the lack of political support for their adoption has led to the current situation. One of the main criticisms against such mechanisms is that they would encourage more opportunistic behaviour by debtor nations. However, as past experience shows and leading institutions have recognised, the problem historically has not been that countries have been too eager to renege on their financial obligations, but that they have often been too reluctant (Blustein 2006). Policy makers often have incentives to postpone the moment of recognising that they do not have alternative choices (Levy-Yeyati & Panizza 2010).

The lack of an international lender of last resort and the lack of an internationally-recognised restructuring framework worsens the situation for countries facing distress. The review and reform of the current situation are essential in order to eliminate uncertainties and to keep sovereign lending operational. The introduction of such a mechanism would be a step forward in respect of the current *status quo*.

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