

## Debt Workout Mechanisms: Debt Arbitration

"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, *Wealth of Nations*, 1776

"I would go a step further and propose that, in the future, we consider an entirely new approach to handling the debt problem. The main components of such an approach would include ... establishing a debt arbitration process to balance the interests of creditors and sovereign debtors and introduce greater discipline into their relations."

Kofi Annan (2000, p.38)

### Introduction

The extremely poor historical record of debt management so far highlights the need for a fundamental change. The Rule of Law, fairness, and economic efficiency must finally be respected by sovereign debt management. Arguing that a neutral, totally disinterested entity is absolutely necessary to find a proper solution this paper demands debt arbitration as the sovereign equivalent of domestic insolvency procedures. After a brief analysis of past debt management and its failure, the paper shows that debt reduction is urgently necessary to reach all Millennium Development Goals (MDGs) that require financial resources. Developing a global partnership for development with regard to dealing comprehensively with the debt problem, which is part of Goal 8, does not need such financing, but a substantial re-design of present North-South relations. Of all proposals made so far my international Chapter 9 is the only viable solution to realise this. It would finally transform and civilise international creditor-debtor relations by extending the Rule of Law and the protection of human dignity to the poorest of the globe.

After presenting the cornerstone of my model, arbitration, the paper explains how it accommodates debtor protection, financing needs to reach the MDGs, how sovereignty is safeguarded in a way fair to *bona fide* creditors, and why multilateral debts must not be given preference. Finally, concrete recommendations for actors willing to campaign in favour of an international Chapter 9 are presented.

### Past Failures Aggravating Present Problems

In spite of decades of debt management the crisis persists. The IMF started its first adjustment measures in Sub-Saharan Africa (SSA) some 30 years ago, without any tangible success, as

data on the region prove. Sustainable recovery of debtors could not be achieved, and the debt crisis has lingered on. Regarding the poorest countries for which the Highly Indebted Poor Countries (HIPC) Initiatives had been designed, suffice it to refer to the Zedillo Report written at the request of the UN Secretary General. It concluded that HIPC II had "in most cases" (Zedillo *et al.* 2001, p. 21) not gone far enough to reach sustainable debt levels, suggesting a "re-enhanced" HIPC III (*ibid.*, p. 54). Present data on HIPCs fully corroborate this conclusion. By proposing its Sovereign Debt Restructuring Mechanism (SDRM) for relatively richer countries the IMF itself admitted that its own and the IBRD's (International Bank for Reconstruction and Development) debt management could not solve the problem.

This failure is no surprise. All historical cases of sovereign debt overhang prove that debts must eventually be reduced by substantial amounts. The IMF (2003c, p.140) presented research results for the period 1970-2002 that

"suggest that while large debt reductions have often occurred in conjunction with debt defaults there are cases where they have been brought about by a combination of strong economic growth and fiscal consolidation."

19 out of 26 cases "were associated with a debt default." Obviously, reductions were insufficient. The IMF suggests that a "sustainable public debt level for a typical emerging economy may only be about 25 percent of GDP" (*ibid.*, p.142), much less than present problem cases. Further reductions are necessary, as the IMF acknowledges by proposing its SDRM. This passage recalls well known facts from insolvency procedures: while some debtors believed to be insolvent can overcome their problem, most cannot.

Steps into the right direction occurred: various Paris Club "Terms", the HIPC-Initiatives, and debt reductions such as the Miyazawa-Brady initiative, which failed, as Ecuador or Argentina convincingly prove. The problem has invariably been the same: creditors decided, granting too little too late, thus prolonging the problem. Trying to avoid smaller write-offs to go easy on their budgets official creditors allowed debts to grow further thus forcing themselves to accept much bigger write-offs later. Short run bookkeeping formalities have been preferred over workable solutions. Economically, creditors have been fully aware that most claims carried at nominal value in their books are worth only a fraction. The *Washington Post* (16 March 1999) reported that \$3 billion of "forgiven" debt would actually mean "maximum budget cost" of \$190 million (or 6.33% of face value), as the rest had been "essentially written down or written off as incollectible." At the Cologne summit Chancellor Schröder told in an interview that essentially debts were forgiven that could not have been collected. I called these lost claims "phantom debts". They accumulate and exist only on paper - in the books of creditors. Economically they are unreal because they are technically irrecoverable (cf. Raffer 2002b). They cannot be cashed. Caused by creditors unwilling to grant needed reduction in time, debts have been boosted to ever more unrealistic levels. Debt reduction to sustainable levels appears costlier and costlier on paper. But as deleting phantom debts simply acknowledges facts, this does not really cost creditors a single cent. One cannot lose money again that was already lost. Deleting phantom debts simply means putting an end to playing the Emperor's New Clothes, acknowledging the naked economic truth. It is "generosity for free". On the other hand, debtors get no real relief as this part of their debts could not have been paid anyway. The present practice of including phantom debts at face value when estimating the "costs" of debt reductions exaggerates real, economic costs substantially, especially so for SSA. Appropriate debt relief looks more expensive and difficult than it

actually is. Secondary market prices would be a better and economically more appropriate indicator.

The IBRD (1997, p.42) acknowledged that substantial shares of present debts were caused by creditors delaying necessary reductions over years:

"The surge in borrowing, coupled with increasing reliance on rescheduling and refinancing, increased the nominal stock of debts of HIPC's from \$55 billion in 1980 to \$183 billion in 1990 ... by the end of 1995 it had reached \$215 billion."

Slower growth during the period 1990-5 reflects shifts towards grants, higher concessionality, and effects of debt cancellations. UNCTAD (1998, p.127) estimated two thirds of the increase in SSA-debt since 1989 to be caused by arrears.

With considerable delay the IBRD (1992, pp.10ff stress in original) acknowledged that insolvency, not illiquidity was the problem:

*"In a solvency crisis, early recognition of solvency as the root cause and the need for a final settlement are important for minimizing the damage ... protracted renegotiations and uncertainty damaged economic activity in debtor countries for several years ... It took too long to recognize that liquidity was the visible tip of the problem, but not its root."*

The IBRD failed to act on this conclusion, nor did it recall that the Bretton Woods Institutions had been the most ardent advocates of the illiquidity theory after 1982, which posited that countries would grow out of debts and debt reductions would therefore be unnecessary. The HIPC-initiative went on delaying, granting "completion" after six more years instead of at once. More than a decade after calling insolvency the problem the IBRD has still not started to advocate an appropriately quick solution.

Southern debtors have been denied the obvious and humane solution - some form of insolvency procedures as already suggested immediately after 1982 by a British banker, David Suratgar. Instead, new creditor groups were brought into the game, prolonging unnecessary suffering by debtors, and increasing total debts in a huge Ponzi scheme (cf. Raffer fc1). Multilateral money bailed out commercial banks during the 1980s. New lenders, institutional investors and the public at large, allowed "old" creditors to reduce their exposure in the 1990s. The IMF (2003c, p.139) rightly recalls that switching to bonds occurred "largely on account of official encouragement and guarantees" as well as "regulations in financial markets". Official encouragement and euphoria were in stark contrast to official data available before the 1994-5 crisis, such as the IBRD's own data that did not justify official statements (Raffer, 1996). Latin America's substantial debt overhang persisted, the "end of the debt crisis" was explained by the toleration of extremely large non-payments, or breaches of contract in spite of new inflows. Both waves of new money increased the debt burden rather than reducing it. Now economic reality has to be faced as no new group of creditors is available, no further shift possible. The game of financial musical chairs is over. Losses have to be recognised and distributed.

Creditors as a group will have to accept larger losses than would have been necessary some 20 years ago in order to regain the sustainability of debtor economies. But not all creditors will necessarily be worse off. The structure of creditors has changed dramatically over the last

two decades. Bondholders, practically non-existent in 1982, are now an important class of creditors in quite a few cases, while banks have been able to reduce their exposure. Argentina is a good illustration: the share of bonds in public and publicly guaranteed long term debt rose from 8.2 per cent to 74.23 per cent, and the share of commercial banks declined from 59.6 per cent to 8.3 per cent between 1980 and 1999. Quite noteworthy distributional effects exist, exacerbated by the fact that IFIs were able to secure a privileged status of *de facto* preferred creditors, mostly in breach of their own constitutions. This undue privilege is especially problematic for the poorest countries where multilateral claims are a substantial percentage of sovereign debts and IFIs have influenced economic policies substantially.

Recognising economic facts long denied by IMF-personnel, Krueger (2001, p.8) finally declared: "At the moment too many countries with insurmountable debt problems wait too long, imposing unnecessary costs on themselves, and on the international community that has to help pick up the pieces." She failed to mention that creditors, most notably the IMF itself, had blocked this sensible solution, forcing debtors to "wait too long", thus damaging debtor economies severely. Substantial shares of present debts exist only because of prolonged, unsuccessful debt management by official creditors refusing necessary debt relief over decades. The debt burden has grown, impoverishing people further. This is creditor caused damage - both in middle income and in HIPC countries. One has to agree with Krueger that this damage should better have been avoided.

While debt management has not provided a solution, it has affected North-South relations fundamentally. It provided political leverage to the North, also allowing creditors to change the policies of debtors. The economic sense behind a "solution" such as the debt service option, under which Cologne Terms with 90 per cent Net Present Value reduction on eligible debts is achieved "through concessional interest rates and a repayment period of 125 years, including 65 years of grace" (IBRD 2000, p.171) remains unclear at best. Similarly, the "'bullet' option" with an interest rate of 0.0001 per cent (the IBRD does not dare write over how many years) would be ridiculed in the case of all other debtor-creditor relations. Politically, though, such solutions provide a long term leverage over poor countries.

Rodrik (1996, p. 17) pointed out that the debt crisis was seen as an opportunity for a "wholesale reform of prevailing policies", a chance "to wipe the slate clean and mount a frontal attack on the entire range of policies in use." A crisis brought about by overspending and overlending in globalised credit markets and the sudden change of Northern economic policy sending interest rates skyrocketing around 1980 was simply declared to stem from too little globalisation: import substitution and "inward looking" policies. Distinctions between bad and proper import substitution were not made, even though the Asian tigers had used these discredited policies to good effect before they started neoliberal globalisation. The crash of the globalised credit market provided leverage for further globalisation in the South and for enforcing policies the IMF or other creditors wanted debtors to pursue, so much so that "ownership" of reform programs has been discussed. In plain English: it is doubted whether countries actually want to implement what are officially declared to be "their own" policies.

Meanwhile, continuing as before has become impossible. At present four proposals are on the table (cf. Raffer 2003 as well the other papers of this panel at the DMFAS-homepage). These are Collective Action Clauses (CACs), a voluntary Code of Good Conduct for debt re-negotiation first proposed by the Banque de France, and two models of sovereign insolvency: the IMF's SDRM, and the proposal of internationalising the basic features of US municipal insolvency, so-called Chapter 9 (of Title 11 US Code, Bankruptcy). The latter model has been widely supported by NGOs. In 1990 the Working Group Swissaid/ Fastenopfer/ Brot für alle/

Helvetas/ Caritas submitted the idea of an international insolvency to the Swiss *Bundesrat*, supported by two papers written by Prof. K.W. Meessen (Augsburg/Geneva) and myself. The Swiss Parliament discussed it. Switzerland tried discreetly to discuss this proposal internationally, but finally stopped these attempts as no other creditor government signalled any interest. NGOs often prefer to call it Fair and Transparent Arbitration Process (FTAP). Jubilee2000 UK was the first Jubilee-organisation advocating it, others, such as the German Jubilee movement or Jubileo 2000, Red Guayaquil in Ecuador followed. The Declaration of Tegucigalpa, the platform of Latin American Jubilee movements, explicitly calls for an international Chapter 9 insolvency.

Often it is alleged that the former two proposals contradict or preclude sovereign insolvency. This is fundamentally wrong. Helping creditors to organise, to be able to act more quickly and efficiently, CACs are a helpful component of any insolvency rather than a contradiction to it. The proper functioning of fair insolvency procedures depends on the full ability of parties to defend their legal and economic interests. Creditors must be able to act efficiently - whatever helps them to do so is welcome. The Code of Good Conduct demands fair representation of creditors, an expeditious and co-operative process, fair burden sharing, preserving the debtor's financial situation, reaching debt sustainability as soon as possible, also arbitration - briefly, many elements of Chapter 9 insolvency.

Whenever CACs or the Code should be able to prevent formal insolvency procedures this would be great. The very existence of an insolvency mechanism would be helpful in making these options more efficient. Sovereign insolvency is a solution of last resort, an emergency exit necessary and useful, but better avoided. Any sane interceptor pilot insists on having an ejector seat and on making sure it works perfectly. But no sane pilot uses it for ending routine flights, or if (s)he can land the plane. Like an emergency seat, insolvency is not an easy way out. It is a thorny choice, not least to the debtor. However, the two models of sovereign insolvency, the IMF's SDRM and my Chapter 9 based debt arbitration contradict each other.

### **The Essence of Insolvency**

The basic function of any insolvency procedure is the resolution of a conflict between two fundamental legal principles. In a situation of overindebtedness the right of creditors to interest and repayments collides with the principle recognised generally (not only in the case of loans) by all civilised legal systems that no one must be forced to fulfil contracts if that leads to inhumane distress, endangers one's life or health, or violates human dignity. Briefly put, debtors cannot be forced to starve themselves or their children to be able to pay. Although their claims are recognised as legitimate, insolvency exempts resources from being seized by *bona fide* creditors. Human rights and human dignity of debtors are always given priority over unconditional repayment, unless debtors happen to be developing countries and their inhabitants. It is important to emphasise that insolvency only deals with claims based on solid and proper legal foundations. In the case of odious debts, e.g., no insolvency is needed. These are null and void. Demands for cancelling apartheid debts are therefore based on the odious debts doctrine.

### **Arbitration - The Cornerstone of any Fair and Efficient Solution**

The acronym FTAP characterises the cornerstone of my proposal. All legal systems demand that a neutral and totally non-interested entity must decide which percentage of debts insolvent debtors are able to repay. Even during the period of debt slavery and debt prisons judges - not creditors - decided on the debtor's fate, which compares favourably with present international debt management. Past initiatives could not solve the problem because of absolute creditor domination. Creditors have been judge, jury, experts and bailiff all in one,

sometimes even the debtor's lawyers. This is a grave violation of the very foundation of the Rule of Law barring parties from also being judges: one must not be judge in one's own cause.

As the long and successful record of national insolvency laws shows, establishing neutral disinterested entities is not only fair, but also the only economically wise and workable arrangement. Refusing to do so is the main cause of unsuccessful debt management. The powerful position of official and especially multilateral creditors vis-à-vis poor countries such as HIPC's or most of SSA makes an independent entity all the more urgent. Neutral arbitration is not only a solution for emerging markets but equally if not more important in the case of poor countries. Insolvency relief is not an act of mercy but of justice and economic reason. This shows down to negligible details such as the fact that the word "forgive" is not normally used if and when insolvency procedures reduce debts. This relief is a right of insolvent debtors. Only developing countries' debts are "forgiven". They have remained the only debtors that are refused insolvency protection.

In my model the neutral entity would preferably be an *ad hoc* arbitration panel established by the debtor and creditors. Each party would nominate one or two persons. These nominees would elect one further member for an uneven number, as is traditional practice in international law. Ironically, this procedure is also foreseen pursuant to Section 10.04 of the IBRD's (1985) *General Conditions* determining how to establish arbitration panels. They further provide that the third person shall be appointed if the parties do not agree. Arbitration is foreseen to settle disagreements with borrowers, be they members or not, *inter alia* for "any claim by either party against the other" not settled by agreement. One might therefore be surprised why the IBRD does not show more sympathies for debt arbitration.

Naturally, the debtor government can choose to leave the task of nominating panel members either to the parliament or the people. Arbitrators could be elected from a roster by voters. Anyone reaching a minimum of supporting signatures by voters would have to be on it. Alternatively, one arbitrator might be chosen by parliament, the other by voters. My model offers a wide range of possibilities to allow democratic participation by the affected. Or, the parliament might establish a special committee for this purpose including members of the cabinet, as proposed in a bill drafted on the initiative of Congressman Mario Cafiero by the Argentine opposition party ARI. The bill would establish a Comisión Representativa del Estado Nacional. Consisting of members from both Houses and the executive power, it should nominate panel members and represent Argentina during the proceedings. In the case of a change of government, which has occurred quite often in indebted countries, a new, incoming government might be prepared to opt for one of these very democratic possibilities.

The main principles of domestic US Chapter 9, such as protection of the debtor's governmental powers, the right of the affected population to voice their views, and the best interest of creditors would form the base on which the arbitration process would rest. Evidently, some important and necessary details of domestic Chapter 9 are unnecessary and inapplicable internationally. Eligibility and authorisation to be a Chapter 9 debtor - fundamental and useful within the US for constitutional reasons - are one example.

Arbitrators would have to mediate between the parties, chair and support negotiations by advice, provide adequate possibilities to be heard for the affected population, and - if necessary - decide. This is important because mediators without any authority to decide will normally be less successful in mediating as well. Decisions - if needed - are unlikely to affect substantial sums of money but rather to solve deadlock situations because all facts will be on the table. For obvious reasons justified opposition by creditors should not be simply

overruled. "Agreements between debtor and creditors would need the confirmation of the arbitrators, in analogy to Section 943" (Raffer 1990, p.305; similarly Krueger 2002, p.7) They would have to take particular care that fairness and a minimum of human dignity of the poor is safeguarded - in analogy to the protection enjoyed by a municipality's inhabitants.

Sovereigns could "file" for "insolvency protection" or debt arbitration by depositing their demand at the UN. Acting as a registration office - or "post box" - the UN, for instance the Secretary General, would make this demand publicly known and serve as the place creditors can contact. It could also help to organise the panel. Filing would automatically trigger a stay. The panel must endorse the standstill immediately on being formed. The IMF first proposed that it be given the authority to approve standstills. Attempting to placate private creditors the Fund later made several proposals later, including clumsy procedures whose economic result would at best be the same as a general stay (cf. Raffer 2002a, fc2). Thus allowing the neutral entity to decide whether to endorse the stay, as usual in all domestic laws, is preferable.

Naturally, the panel would have to reject the debtor's demand if unfounded, denying this debtor any advantage from starting the procedure. The panel would have to deny approval of a plan if the debtor has the means to honour all its obligations subject to debtor protection. It should verify claims, as is routine in any domestic case, in order to apply the same legal standards as in the North. In many discussions representatives of official creditors, especially of IFIs, had declared this proposal (Raffer 1990, p. 309) too utopian and impossible to implement. Meanwhile it became part of Krueger's "new approach". The IMF (2002b, p.68) demanded specific checks regarding "for example, the authority of an official to borrow on behalf of the debtor", echoing what had been demanded some ten years before (Raffer 1993b, p. 68), nearly in the same words.

Should disagreement regarding the implementation of the debtor's plan arise after the panel is dissolved, the panel could reconvene. There is no need to involve the IMF (2002, p.26) by creating new debts with the IMF to obtain "an appropriate means for the Fund to signal its disapproval". Nor for a new IMF-mandate to sanction debtors if and as the IMF (2002,p.54) might think it appropriate.

Clearly, arbitration panels could sit anywhere, including the debtor or its neighbouring countries. To facilitate participation of the representatives of the population it should be in the debtor country or close to it. I never demanded that the panel "be headquartered in a neutral country that is neither an active international lender nor borrower", as Eichengreen (1999, p.126) erroneously characterised my proposal. One may suppose this error to stem from the passage: "The reason why no court, whether located in a creditor or debtor country, should chair the procedures is self-evident: its impartiality is not guaranteed" (Raffer 1990, pp.304f), which refers to courts, not courts of arbitration. Language apart, the illustrating example - the US Court of Appeal for the Second Circuit of New York, definitely no court of arbitration - proves this beyond doubt. However, if a distinguished economist misunderstands this point, this should obviously be clarified.

Unsurprisingly, the IMF (2002, p.63) tries to find an argument against *ad hoc* panels. As claims would have to be verified first

“to be recognized for participation in decision-making ... the selection of a panel would have to follow, not precede, the verification process. But then who would resolve disputes arising from verification if there was [sic!] no panel already in place?”

The answer is simple: all registering creditors nominate their arbitrator(s) who immediately decide(s) on the recognition of claims. CACs would be helpful to organise this process more quickly. Recognised creditors could either confirm their nominees or replace them. The latter could theoretically become necessary if so many claims are excluded that different arbitrators would have been nominated by the remaining creditors, which - though possible - seems unlikely to be the normal case. As creditors are known and organised, endorsing or replacing could be done quickly. Creditors whose claims are dismissed are party and should have the same right to nominate arbitrators judging on their case as anyone else. To back up a weak point the IMF adds that creditors might each wish to appoint their own arbitrator, which would make the case unmanageable and "could distort the balance of power between the debtor- and creditor-selected arbitrators." This only holds if the nominees are not impartial arbitrators but actually represent and defend the interests of certain groups, an erroneous perception shared by Rogoff and Zettelmayer (2002a). Whatever such procedure might be, it would no longer be arbitration. In this case, of course, anyone would like to have their own "defenders" or "lawyers". This problem never occurred in the few cases when private creditors and sovereign debtors agreed on arbitration on debt issues so far. Compared with having to accept the IMF's choice, my proposal definitely confers more rights on creditors.

Both in my model and under the SDRM private creditors - but not official creditors - are equally subject to the entity's decisions. Although having no authority to challenge decisions made by the IMF's Executive Board, the Dispute Resolution Forum would be vested with substantial powers over private creditors and debtors. It could decide on the validity and value of claims, the right to vote or the classification of creditors, all of which can have grave financial consequences. It may not recognise a claim. Its decisions could initially not be challenged. The appeal panel suggested later would still be part of the Forum. Within its mandate this IMF-body would have no lesser authority than the arbitration panel established by the parties. In contrast to debt arbitration the parties would not be allowed to negotiate necessary reductions but would have to accept the IMF's decisions.

### **Protecting Sovereignty**

The need to deal satisfactorily with sovereignty was used as a powerful argument against the first generation of proposals advocating the application of corporate insolvency (Chapter 11) in the early 1980s. As corporations are not sovereign, it was argued, Chapter 11 would be inapplicable. To counter this legalistic argument I proposed US Chapter 9, Title 11 – municipal insolvency – as the model in 1987 (Raffer 1989). Solving the problem of governmental powers it is tailor-made for sovereigns. Forgetting its own important objection the IMF itself now proposes Chapter 11 as the blueprint for its SDRM. None of the Fund's SDRM-documents mentions any measure to protect the governmental powers of debtors.

In the US the court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators. This makes Chapter 9 especially suited for sovereign cases. The concept of sovereignty does not contain anything more than what §904 (titled: "Limitation on Jurisdiction and Powers of Court") protects:

- “Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with -
- (1) any of the political and governmental powers of the debtor
  - (2) any of the property or revenues of the debtor; or
  - (3) the debtor's use or enjoyment of any income-producing property.”

Unlike in other bankruptcy procedures liquidation of the debtor or receivership are not possible. No trustee can be appointed (§926, avoiding powers, if seen as an exception, is very special and justified). §902(5) explicitly confirms: "'trustee', when used in a section that is made applicable in a case under this chapter ... means debtor". Change of "management" of US municipalities (i.e. removing elected officials) by courts or creditors is not possible - nor should it be in the case of sovereigns. If any regulatory or electoral approvals are necessary under nonbankruptcy law in order to carry out a provision of the plan, §943(b)(6) requests that this must be obtained before the court can confirm the plan, a point clearly adaptable to sovereigns.

During the Great Depression Chapter 9 was introduced precisely to avoid prolonged and inefficient negotiations and reschedulings, allowing a quick, fair, and economically efficient solution for overindebted US municipalities. A first draft by municipalities that did not bar creditor intervention into the governmental sphere was rejected by lawmakers as unconstitutional (Spiotto 1993). Creditor interventions such as those usual in Developing Countries nowadays were considered unacceptable. A new version containing §904 was allowed to pass. This demonstrates the appropriateness for sovereign debtors. Technically, Chapter 9 offers the legal possibility to implement an economically sensible solution. It became law for the very purpose to avoid that kind of "debt management" practised internationally for decades. Of all other OECD countries only Hungary has insolvency laws for public debtors - adopted on the advice of private Western consultants after the demise of communism. Other governments seem to assume quietly and against historical evidence that public debtors cannot become insolvent.

The powerful position of the debtor might make people, especially non-economists, doubt whether Chapter 9 actually works. Some 500 cases within the US so far show it does. As the debtor needs a solution it must offer something that is acceptable to creditors. Composition plans should be fair, equitable, and feasible. Furthermore, to be confirmed the plan has to be reasonable and also in the best interest of creditors pursuant to §943(b)(7), who must be provided the "going concern value" of their claims. The note to §943, 11, USCA specifies:

"The going concern value contemplates a 'comparison of revenues and expenditures taking into account the taxing power and the extent to which tax increases are both necessary and feasible' ... and is intended to provide more of a return to creditors than the liquidation value if the city's assets could be liquidated like those of a private corporation."

A court decision further clarified that a plan can only be confirmed if it "embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle". This openness and transparency of procedures are of particular interest for sovereign debtors.

### **Debtor Protection, Human Rights, and MDGs**

Debtor protection, one main principle of all civilised insolvency laws, remained totally absent in international debt management over many years. HIPC II finally introduced the idea of debtor protection, although still in a rudimentary form. Nevertheless its anti-poverty programmes are a move into the right direction and a change from the position held more than a decade ago in discussions on Chapter 9 that debtor protection would be impossible. By contrast, none of the IMF's documents mentions debtor protection, thus falling behind the standards already established by the HIPC-initiatives. Private creditors accept that there are

politically uncollectable debts, which describes the principle of exempt resources in other words. Unlike the Fund they have repeatedly granted substantial debt reductions. Speaking of "bailing-in" the private sector is therefore misleading and absurd.

Chapter 9 knows two instruments to protect debtors:

- exempting a minimum of resources needed to allow debtors to go on functioning, and
- the right to be heard of the affected population.

#### *Exempt Resources - The Means to Protect Human Rights*

Insolvency laws guarantee insolvent debtors a modest yet humane standard of living, and usually a fresh start by exempting resources that could be seized by *bona fide* creditors. Domestic Chapter 9 in the US exempts resources necessary to finance minimum standards of basic health services, primary education, and an economic "fresh start" as insolvency laws put it. The debtor's population is protected by the right to be heard and legal limits to tax increases. A public interest exists in the continued functioning of municipalities. Tax increases that would depress the standard of living of the municipality's population below the minimum guaranteed to private debtors are clearly illegal. Feasible tax increases have actually been much lower. In the 1930s, when some creditors insisted on higher payments by the City of Asbury Park - financed by tax increases - refusing to agree to the plan, the US Supreme Court clearly stated: "The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power." (Malagardis 1990,p.68)

By contrast any protection has been denied to the poor in the South. The case of Malawi discussed in the Treasury Select Committee (2002) illustrates this difference clearly. Malawi was forced to sell maize from her National Food Reserve to repay loans. In a BBC interview Malawi's president said the government "had been forced [to sell maize] in order to repay commercial loans taken out to buy surplus maize in previous years" (Pettifor 2002, cf. also Treasury Select Committee 2002). After harvest problems in 2002 famine struck. 7 million of a population of 11 million were left severely short of food according to Action Aid. This priority of creditor interest over survival - nowadays uniquely possible in the case of Southern debts - must be abolished. My proposal would make cases such as Malawi no longer possible. The life and the human dignity of people must be equally respected and protected everywhere, be it North or South.

The situation of debt distressed countries shows clearly that resources necessary to finance the MDGs must be freed. Money that has to be paid to creditors cannot be used to improve maternal health, to reduce child mortality or the proportion of people without sustainable access to safe drinking water or suffering from hunger. It is not available to finance primary schooling for all boys and girls, nor to finance the elimination of gender disparities in education. One cannot have one's cake and eat it as well. The introduction of user fees and their effects on the poor prove this point clearly and sadly. In analogy to the protection enjoyed by the population of indebted US municipalities, the money to service a country's debts must not be raised by destroying basic social services and the debtor's future. The principle of debtor protection demands exempting resources necessary to finance humane minimum standards for the poor, and a sustainable economic recovery.

This exemption can only be justified if exempt money is demonstrably used for its declared purpose (cf. Raffer 1990, 2001). A transparently managed fund financed by the debtor in domestic currency would do so. In a discussion with public servants of the G7 and representatives of the Bretton Woods Institutions Ann Pettifor (1999) proposed a Poverty

Action Fund as a means to guarantee that the money is actually used for the poor and for expenditures necessary for a fresh start of the debtor economy. This idea was taken up by a bill at Capitol Hill. The Debt Relief and Development in Africa Act (H.R.2232) sponsored by Rep. Maxine Waters in 1999 required a Human Development Fund organised in a similar way, which would get money freed by HIPC debt relief. This bill was referred to a Subcommittee and did not pass Congress, though.

The management of this fund could be monitored by an international board or advisory council consisting of members from the debtor country as well as members from creditor countries. They could be nominated by governments (including the debtor government), creditors, and NGOs.

Naturally, financing MDGs would be a prime task of any such fund. This should be written into its statutes. As this fund would be a legal entity of its own, checks and discussions of its projects would not concern the government's budget, which is an important part of a country's sovereignty. Furthermore, aid financing MDGs could also be channelled through this fund, changing its character of money just set apart from the ordinary budget towards a normal fund for the poor. However, unless one assumes unrealistic increases in Official Development Assistance in the near future, most MDGs cannot be reached without freeing resources presently used for debt service. In contrast to phantom debts this is money that could technically be taken away from debtors to be used for payments in the same way a winter coat could be taken from a debtor to recover a larger share of creditor claims. Like in the case of private debtors this must not be allowed to happen. Safeguarding the human right of debtor protection and MDGs would thus mean real losses. As most if not virtually all debt service goes to public creditors in the case of the poorest countries, debtor protection and exempt resources logically mean losses by public - bilateral and multilateral - creditors.

Freeing resources in favour of the MDGs and development is particularly important for SSA, where human distress caused by debt pressure is most pronounced. Sub-Saharan debts differ from Latin American debts by their structure. But there is even less reason to allow creditors to go on being judges. Quite on the contrary: as creditors, especially multilateral institutions, have largely influenced if not outright dictated debtors' policies there exists an additional reason why official creditors have to accept financial accountability for their actions. As will be argued in more detail below, reducing their claims like private creditors who have never interfered with their clients' economic policy is an economic necessity and an act of fairness towards private creditors and the debtor. The present victims-pays-principle is a unique arrangement, which cannot be justified by economic or legal reasoning (cf. Raffer 1993a). It must be substituted by decent legal arrangements. My Chapter 9 proposal does so. If anything, the foundation of the Rule of Law, neutral decision making, is all the more important and needed in SSA, a region where creditor domination is one important root of present problems.

#### *Right to be Heard*

In a domestic Chapter 9 case the affected population has a right to be heard. Internationally, this would have to be exercised by representation. Trade unions, entrepreneurial associations, religious or non-religious NGOs, or international organisations such as UNICEF could represent the debtor country's population. Depending on the country, e.g., Christian organisations in Latin America or Muslim organisations in Muslim countries, could be formal representatives. Besides preserving essential services to the population my proposal gives the affected population and vulnerable groups a right to be heard. In a most powerful way it gives voice to those who have been denied participation.

Errors regarding this part of my proposal in the literature suggest clarifications. The brief description of my panel by Rogoff and Zettelmeyer (2002a), an impressively comprehensive - but not always accurate - survey of publications on sovereign insolvency before Krueger's (2001) "New Approach", is fundamentally wrong. In analogy to domestic Chapter 9 I proposed a right to be heard of the population. Pointing out that the principle of representation is known in US domestic cases I argued: "Exactly like in Rule 2018, this could be done by trade unions or employees' associations." (Raffer 1990, p.305) Unlike domestic US laws I suggested further organisations, such as UNICEF, churches, "Catholic NGOs, or similar organisations of other creeds (especially in countries with non-Christian majorities), NGOs without religious background ... last and by no means least - grass-roots organisations of the poor." In Rogoff and Zettelmeyer (2002a, p.10) this boils down to "trade unions, NGOs or churches could function as arbitrators speaking on behalf of the citizens in the debtor countries." Clearly, a right to be heard does not make someone an arbitration panel member. This right is a useful instrument in domestic Chapter 9 to allow affected people, such as special taxpayers affected by the plan, to voice their views. But like witnesses they are not judges. Nor should arbitrators speak on behalf of any interested party. In a fair procedure they must be totally disinterested and neutral. Rogoff and Zettelmeyer (2002b) corrected this misunderstanding later.

In contrast to the late 1980s when giving voice to the affected was first demanded (Raffer 1990), the idea that "stakeholders" should be allowed to voice their views is meanwhile more accepted, at least in theory. Civil society participation is officially part of HIPC II, although practical results are lag behind. Recently the IMF (2003b) stated

“creditors are likely to express views as to the appropriate dimensions of the program’s adjustment and financing parameters. While such input would be welcome, Directors emphasized that it would be inappropriate for private creditors to be given a veto over the design of the financing plan or the design of the adjustment program.”

This sounds slightly more participatory than earlier ideas under the SDRM, where the IMF's Executive Board would take all important decisions, especially the adequacy of a member's policies and the sustainability of the member's debt. As the IMF determines sustainability and economic policies, only one practically important decision is left to creditors. Creditor majorities can refuse to accept the result, leaving, however, the problem unsolved and possibly encouraging the IMF to support the debtor. All remaining decisions on terms can only affect relatively minor issues, such as repayment schedules of  $n$  or  $(n+k)$  years. In practice there is very little substance on which private creditors can actually vote, in spite of IMF-rhetoric of empowering creditors and the debtor. They could vote on how to share losses among themselves. Theoretically, they could also grant more reduction than the Fund suggests.

### **Sustainability**

As facts would be presented by both parties and the representatives of the population in a transparent procedure before the arbitration panel, the debtor's capacity to pay and sustainability would emerge fairly reliably from this process. Defending their legitimate self-interests anyone would present data and arguments to corroborate their views, thus narrowing down the set of feasible options considerably. By contrast, the IMF alone would continue to decide under the SDRM. Apart from the fact that decisions by a creditor violate the Rule of Law and that it is very likely to be unfair to other creditors, the record of IFIs in estimating

sustainability urgently calls for change. Their overoptimistic estimates have been one main cause for the failures of the past. They have damaged debtor economies gravely.

Debt sustainability analysis highlights the inefficiency of IFI-programs most clearly. Over decades too optimistic forecasts have inflicted damages on member countries, rendering strategies based on such forecasts, especially debt reductions, useless. Recently, IMF and IDA (2004, p.13) themselves conceded

"past experience suggesting a systematic tendency toward excessive optimism ... a common theme behind the historical rise in low-income countries' debt ratios was that borrowing decisions were predicated on growth projections that never materialized. This experience points to the need for well-disciplined projections, including by laying bare the assumptions on which they are predicated and by subjecting them to rigorous stress tests that explicitly incorporate the impact of exogenous shocks. ... analysis of projections made by Fund staff over the period 1990-2001 suggests a bias toward over-optimism of about 1 percentage point a year in forecasts of low-income country real GDP growth. The bias in projecting GDP growth in U.S. dollar terms, however, was considerably larger, at almost 5 percentage points a year."

There doubtlessly exists a need for such well-disciplined projections. This passage admits that the Bretton Woods Institutions have continuously done overoptimistic forecasts, not well-disciplined projections whose assumptions were not explained and which were not stress tested over decades. Any normal clients could successfully sue their consultants and get financial compensation. But basic legal principles cease to be in force whenever they would protect Southern debtors and poor people in the South.

Assessing HIPC II on congressional request the US General Accounting Office (GAO 2000) corroborates doubts about the reliability of IFI estimates and thus the professionalism of IFIs. Debt sustainability depended on annual growth rates above 6% in US dollar terms over 20 years - in four cases including Nicaragua and Uganda even above 9.1%. Understandably, the GAO doubted whether such rates could actually be maintained for that long, warning also about the volatility of commodity prices. It pointed out that additional money would be necessary. Like so many creditor initiatives before, HIPC II was apparently again built on fragile, optimistic assumptions and forecasts. Its failure is a logical result. The need for changes in the way sustainability is calculated is obvious.

### **Fairness, Equality of Creditors, and Multilateral Debts**

Unlike the IMF's SDRM, my proposal is fair to the private sector and to debtors. Debtors would no longer be under the thumb of any one creditor, but - as usual in all other cases - be one party. My model demands inter-creditor equity and safeguarding of the best interest of creditors. All debts, including multilateral claims, must be treated equally. There is no legal nor statutory base for preferred treatment of IFIs as granted *de facto* by creditor governments and mostly accepted by the private sector. In September 1988, e.g., the Interim Committee urged all members to treat the Fund as a preferred creditor within the limits of their laws. Aware of the situation, the IMF tried to use its SDRM to legalise this IFI-preference in a self-serving way. Accepting the IMF's (2003c, p.142) 25% of GDP sustainability level for

emerging markets' public debts, and plausibly assuming that it cannot be higher for the poorest countries one can immediately calculate extra losses other creditors would have to take to bail out IFIs if the SDRM had been established.

IFIs insist on full repayment, even if damages negligently caused by their staff occur, which have to be paid by borrowers. This has created a perverted incentive system totally at odds with any market economy: a high rate of IFI-failures is bound to render adjustment programmes necessary, which are again administered by IFIs, just as failed programmes are likely to call for new programmes, as long as unconditional repayment to IFIs is upheld. An institutional interest was allowed to develop that is at odds with efficiency, economic logic, and even the statutes of IFIs themselves. Results are unsurprising as debt management proves.

Like any other creditor IFIs must carry the risk of losses. Like consultants they must be financially responsible for their decisions. Decisions must be connected to risks. The most basic condition for the functioning of the market mechanism demands so. If this link is severed market efficiency is severely disturbed, as former communist economies clearly prove. Economic efficiency, but also fairness to debtors and other creditors demands that IFIs, at least co-responsible for the present mess, should no longer be treated with preference. Equal treatment of all creditors if debtors acting on IFI-advice become insolvent is the easiest way to introduce financial accountability. As IFIs have influenced economic policies of debtors to the extent of sparking the "ownership" discussion, this is economically mandatory.

Argentina provides a telling example of the difference between the market and IFIs. *Clarín* (29 November 2003) reported that a German court had sentenced a bank to compensate a client whom it had advised to buy Argentine bonds as safe yet high yielding investments. The court followed the plaintiff's argument that the bank did not explain Argentina's already known difficult situation sufficiently, ordering the bank to indemnify its client fully because of the advice it gave. In sharp contrast, any protection is totally absent when it comes to IFIs that even benefit from their own negligence and errors. If normal accountability standards applied to Southern debtors, there would be no multilateral debt problem.

The statutes of all multilateral development banks foresee default of sovereign borrowers and appropriate ways of recognising losses. These banks have to form provisions pursuant to their statutes. All have the authority to modify the terms of loans other than the currency of repayment after or to avoid defaults. Article IV(6) of the IBRD's Articles of Agreement demands a special reserve to cover what Article IV(7) calls "Methods of Meeting Liabilities of the Bank in Case of Defaults". Detailed rules how to proceed follow. The Agreement Establishing the Inter-American Development Bank provides for "Methods of Meeting Liabilities of the Bank in Case of Defaults" (Article VII(3)). Charges should first be made "against the special reserve provided for in Article III, Section 13", which is to meet the Bank's liabilities in the case of debtor default. The statutes of the Asian Development Bank similarly demand a special reserve to meet liabilities in the case of default (Article 17). Article 18 gives the detailed description how to proceed already known from the IBRD and the Inter-American Development Bank. In the case of the African Development Bank these rules are apparently enshrined in Articles 20-22. As the AfDB's homepage does not grant access to the text of its own statutes – an absolutely unique case - this can only be inferred from the headings displayed. Clicking the links, though, brings one straight to the Bank's "visions", rather than its statutes (an e-mail describing the problem and asking for the legal text was received according to AfDB's computer, but not answered). The European Bank for Reconstruction and Development recognises losses and survives.

Initially, IMF drawings provided short term emergency finance without any conditionality to allow members to stay within the exchange rate limits set by the Agreement. Therefore loan loss provisions were unnecessary for the IMF. When conditionality was introduced, no appropriate changes making the Fund financially accountable were made. Nevertheless, the Fund has built up loan loss provisions for quite some time after refusing to accept reality first. Economic facts asserted themselves. The 1986 audit raised the possibility that the next one might have to be qualified if the Fund did not take clear steps to recognise the poor quality of some assets and claims (IMF 2001a, p.814) Forced by external auditors the IMF started to provide for non-payment. These resources, however, are not called loan loss provisions. The IMF's "precautionary reserves consist of General and Special Reserves and the SCA-1." (IMF 2003a, p.3). Its Articles of Agreement do not demand it, but provisioning is not prohibited. The Fund's margin includes a surcharge to "generate resources for a SCA-1, established specifically to protect the IMF against the risk of loss of principal resulting from arrears." (*ibid.*) SCA means Special Contingent Account. The Fund already considered the use of value at risk models. The IMF (2004, p.26) had precautionary balances of about SDR 6 billion or 8.5% of credit outstanding as of end October 2003. It had decided to bring these reserves to SDR 10 billion. The IMF is prepared to take losses, charging members the costs of defaults but refusing like all IFIs to use the money for the purpose it has been accumulated for. All other IFIs have much higher "precautionary balances", ranging from slightly more than 20% (IBRD) to over 30% (Inter-American Development Bank) of credit outstanding. As current countries have already paid for provisioning, using these resources cannot mean that costs of borrowing increase.

This should not be misunderstood as criticising IFIs for provisioning. Quite on the contrary - this economically sound and financially very prudent. What must be criticised severely is that these reserves are not used sensibly. At present, clients have to pick up the bill, but do not get relief when needed. This is comparable to an insurance company charging necessary fees but refusing to cover damages. Of course, no private firm would be allowed such behaviour.

The Articles of Agreement of the International Development Association (IDA), which is especially important for SSA, are somewhat vague. Pursuant to Article V(3), titled "Modifications of Terms of Financing", IDA may "agree to a relaxation or other modification of the terms on which any of its financing shall have been provided". In the case of maturities of 35, 40 or even 20 years with 10 years grace periods and "no interest charge" (IDA 2004, p.2) this leaves little realistic alternatives but outright grants. Meanwhile, IDA 13 foresees between 10 and 25 per cent of grants depending on absorptive capacity and country performance. The argument that amortisations needed to refill IDA funds would preclude debt relief is thus no longer valid. Grants to finance basic education or health as recommended by Raffer and Singer (1996, p.209f) do not create re-flows - just like cancelled IDA-debts. If grants for projects are possible without harming the functioning of IDA, granting debt relief is logically possible too.

The important contribution of the HIPC-I is finally breaking the taboo of multilateral debt cancellation, a very commendable step by James Wolfensohn. The need to reduce multilateral claims is now accepted. The "argument" that IFIs cannot do so is no longer upheld. Member countries tolerating provisioning are obviously prepared to face economic reality. Under HIPC the IMF already, though reluctantly, reduces its claims via grants. IFIs still enjoy unjustified preferred treatment, though. Multilateral development banks should finally obey their own statutes. Other creditors would no longer have to pay for the consequences of wrong or negligent decisions by multilateral institutions. The market mechanism must be brought to

IFIs, including the IMF, by subjecting them to financial accountability in the same way consultants already are (Raffer 1993a). This market incentive would improve the quality of operations substantially. As SSA proves this is urgently needed. Furthermore, the poorest countries with little debt to private creditors but substantial multilateral shares cannot benefit meaningfully from debt reduction schemes if multilateral debts are excluded.

### **Best Interest of Creditors**

As in the US, the outcome of any internationalised insolvency procedure must also be in the best interest of creditors. The important point of fairness apart, no biased mechanism would be generally accepted, and rightly so. For a sovereign wishing to have new access to credit markets the way the debt overhang is dealt with is critical. If creditors feel that they have been treated fairly, they are likely to be as willing to provide new loans for economically promising projects in the future as creditors usually are after corporate insolvency cases. This might be less important for very poor countries, but is fundamental for countries such as Argentina.

Unlike present Paris Club practice or under the SDRM Chapter 9 would confer the full rights of a party on all creditors. The Paris Club expects private and non-Paris-Club creditors to implement the Club's decisions although they had no say and were not even heard. This is unjust, and refusals to implement other people's decisions must be understood. Furthermore, the weakest actor, the debtor, is told to gain comparable treatment from other, excluded creditors. Should a recalcitrant creditor take debtors to court in a Paris Club member country, debtors will not be protected by the creditor government but lose the case. Putting an end to such absurdities and injustice is thus in the best interest of all *bona fide* creditors. An international Chapter 9 would do so. It would also prohibit any creditor discrimination in order to finance bail-outs of IFIs, improving recovery rates for the vast majority of creditors.

Although not necessary parts of debt arbitration based on Chapter 9, introducing it could also provide an opportunity to abolish legal norms making debt management unduly difficult - called "legal risk" in the literature - and to stabilise the international financial architecture further than mere existence of a sovereign Chapter 9 would. Signalling that lending may be risky and fostering solutions "in the shadow of the law" as Anne Krueger put it, Chapter 9 would provide the right incentives. But in addition, the universal introduction of tax deductible loan loss reserves, as practised on the European continent, would allow an economically virtually costless stabilising feature to function. Tax authorities in countries restricting tax deductibility are implicitly of the opinion that losses occur when the respective entry correcting a loan's nominal value is made in the creditor's books. But loans still kept at face value in the books will have lower factual or real values once the creditworthiness and economic standing of debtors have become doubtful, as the existence of secondary markets proves. From an economic and factual point of view money is actually lost before nominal claims are finally adjusted in the books. Recognising diminished values of claims is just another way of stating that the sum of net assets, and thus the tax base, has declined. To the extent that provisions reflect actual losses in the values of loans already suffered but not yet booked - if loan loss reserves set aside during one year are equivalent to the change in factual values during that year - they do not economically constitute taxable income. Increasing reserves continuously in line with declining factual values would not really cost taxpayers a single cent. Should the economic outlook of the debtor improve these reserves would, of course, have to be reduced accordingly to keep provisions in line with actual values. Tax régimes without deductibility of reserves thus tax illusory profits "existing" only due to accounting practices. Creditors are forced to grant an interest free loan to the Treasury by shifting losses to the future.

In practice, uncertainty will not allow a precise estimate of probabilities of losses (and thus factual values). One might therefore discuss whether reserves actually match losses already suffered. If reserves are larger than these losses banks get a loan by tax authorities equivalent to the difference between reserves and changes in the real values of loans; if reserves are smaller this difference is taxed as illusory income. The costs for reserves of \$100 are  $t$ -times this difference. Or, more formally,

$$\$[100(1 - p) - \text{reserves}]t \quad (1)$$

where  $t$  is the tax rate,  $i$  the interest rate at which either the government or the private creditor can borrow (depending on whose costs are calculated),  $p$  is the probability of repayment -  $100p$  hence the expected value. The first term in square brackets expresses actual losses. Assuming that supervisory authorities keep loan loss reserves roughly in line with the decline in value of dubious loans both costs to taxpayers and taxation of illusory profits will be very low or negligible. A substantial stabilising effect can be obtained at no or minimal real costs to taxpayers.

Economically, provisions have the important function of spreading losses over some years, which might ruin creditors if they had to be absorbed in one year. Whether to have a tax system encouraging more prudential provisioning this way is a political question, which should not be decided without considering the alternatives. Suffice bail-outs such as Continental Illinois or the case of the US Savings&Loan institutions (with a price tag of several 100 billion dollars) to show that extremely limited tax deductibility does not necessarily avoid costs to taxpayers. The introduction of an international Chapter 9 might be used as an opportunity to make the stabilising feature of loan loss provisioning available to all creditors. Rendering crisis management easier, this is ultimately also in the interest of debtors.

### **Speed**

In order to avoid further damages to debtor economies a speedy solution is needed. Chapter 9 based debt arbitration adapts functioning national and international procedures. It could be implemented immediately if and when important creditors, e.g., the G7 agree. Without or against them neither the SDRM nor Chapter 9 could be implemented. No new institution would be created. Panels would dissolve once they would have served their purpose, reconvening later on if needed. As insolvency procedures should and hopefully will remain exceptional in the future - the mere existence of sovereign insolvency would contribute to avoiding crises - a standing institution would soon be severely underemployed.

### **Campaigning for Change**

Safeguarding the rights of Southern debtors by debt arbitration based on Chapter 9 would have positive effects on multilateralism, because it would mean a fundamental change from present international relations, where the rights of Developing Countries have often and repeatedly been infringed. It would reach the MDG-objectives of dealing comprehensively with sovereign debts and re-gaining sustainability, and of introducing a rule based financial system no longer denying equal rights and correct treatment to the South. Abolishing the undue discrimination of Southern sovereign debtors would facilitate global partnership. Real partnership can only be based on equality.

Easily and immediately to implement, my proposal faces only political hurdles and needs being explained to the private sector. Private creditors have usually been much more open. Leading bankers even proposed publicly to emulate insolvency, such as David Suratgar or the late Alfred Herrhausen. Public creditors are much more recalcitrant. For public creditors the Rule of Law would mean giving up power, becoming one party instead of being the judge.

Especially IFIs would lose importance as solved crises no longer need be managed. By contrast the IMF's self-serving SDRM proposal would increase the Fund's importance, installing it firmly and officially as the overlord of sovereign debt relief on top of averting any possibility of holding multilateral institutions accountable for their decisions regarding the policies debtor have to adopt (cf. Raffer 2002a, 2003).

There is a need to convince decision makers that the civilised standards undisputed in the cases of all other debtors must finally be applied to the South. Many public creditors will need lobbying. But there are also people within the public sector who wish such change to be brought about. Parliamentarians have supported debt arbitration, especially in Germany and Latin America. A coalition across the North-South divide must be built between governments in North and South willing to change the present discrimination of Southern debtors and their peoples, international organisations, parliamentarians, public servants, NGOs and the public at large, as well as private creditors interested in re-establishing the economic viability of debt distressed Southern debtors or concerned about the present plight of so many people. These efforts can and should build on already existing networks and support. Public pressure and lobbying is the only way to convince recalcitrant public creditors. It was Jubilee 2000 UK that brought the proposal on the political table, several Jubilee Movements, especially in Ecuador, Germany, or Switzerland, and NGOs have lobbied for it. Thus, it was possible to present it during the UN's *Finance for Development* process. Without public support Chapter 9 or FTAP would have remained another academic idea.

For understandable reasons the dependence of debtor governments on the goodwill (or arbitrariness) of their creditors may hinder many of them to speak up as loudly as they might wish to, and actually should. It is all the more necessary that others speak out strongly and clearly for a just and fair solution putting human dignity and life before debts. A newborn child's life expectancy must eventually be influenced a bit less by whether (s)he is born in a heavily indebted municipality within an OECD-country or in a heavily indebted country in the South.

Besides the economic reasons for such a solution already explained by Adam Smith, there exist ethical and political rationales. If one believes in the equality of all human beings, human rights must be protected for anyone, irrespective of nationality or colour. If the Rule of Law is indeed as important as OECD-governments state, it must be applied universally - including to the debt issue where creditor governments themselves have manifest interests. All members of the UN agreed to the Millenium Declaration stating their determination to deal comprehensively and effectively with the debt problems of developing countries to make their debts sustainable in the long term. Encouragement for efforts to change international debt management to the better might be taken from reading that UN member nations declared:

"We will spare no effort to promote democracy and strengthen the rule of law, as well as respect for all internationally recognized human rights and fundamental freedoms, including the right to development."

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