Consultation on Policy Options for Dealing with the Impact of the Financial Crisis on the External Debt of Developing Countries

Organised by the Financing for Development Office, UNDESA

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Background

This consultation is part of a series of meetings organized by the Financing for Development Office to consult stakeholders on issues related to the debt of developing countries where new issues are emerging as a result of the crisis. The desired outcome is the identification of issues, which lead to the orderly working of the international financial architecture for debt. In addition, the ongoing financial and economic crisis exerts new pressures on developing countries.

In accordance with the commitment to policy actions on debt in the Doha Declaration on Financing for Development (A/CONF.212/7) and the Outcome of the Conference on the World Financial and Economic Crisis and Its Impact on Development (A/RES/63/303), the objective of these consultations is to foster appreciation of the stakeholders of new realities in external debt and the attendant policy issues.

Introduction

Since the onset of the crisis a year ago, the fragile global economic and financial environment has had a perceptible impact on the real economy of developing economies with limited availability of resources to combat the crisis and finance development. The gaps in the working of the international financial architecture for debt can compound this problem. Many developing countries which were hit badly by the recent financial crisis had exercised sound macroeconomic policies, which are conventional remedies prescribed by the Breton Woods Institutions (BWIs). Thus, policy options sought after by this consultation will be focused outside this area.

Since the Monterey Consensus, where the key role of debt relief and debt restructuring was recognized to liberate resources for economic development, the necessity of reviewing the current debt sustainability framework (DSF), further participation of private creditors in debt restructuring, acceleration of debt relief and renewed debt management has been mounting.

The existing international debt resolution mechanisms are creditor-driven, and more efforts are needed to guarantee fair treatment between creditors and debtors. Furthermore, efforts to prevent debt crisis by enhancing international financial mechanisms for crisis prevention and resolution in cooperation with the private sector should be intensified. In these contexts, the Doha Declaration called for exploring enhanced approaches to debt restructuring mechanisms with broad participation of creditors and debtors and comparable burden sharing among creditors.

Following the global financial crisis, the ECOSOC in June 2009 called for temporary capital restrictions and debt standstills to mitigate adverse impacts on development and making full use of the existing flexibility within the DSF to avoid a new debt crisis. Exploration of enhanced approaches to sovereign debt restructuring mechanisms was once again emphasized, in addition to the feasibility of a more structured framework for international cooperation in this area. Furthermore, the G20 Communiqué stressed the needs for providing new resources to the IMF for crisis prevention and debt management and for reviewing "flexibility" in the current DSF.

By analysing the most recent statistical data and forecasts of net-creditor countries as well as reports on debt vulnerability of low income countries after the financial crisis, however, the fragility of economic recovery in low income countries is evident. It is worrisome that speculative short-term capital flows into emerging economies have already started creating asset bubbles. The fundamental problems, therefore, appear to remain in the areas where developed countries and the BWIs have not yet addressed to.

Considering the fact that about 75% of developing countries' debts are owed to the private creditors, the role of the private sector should be stressed more. Roll-overs of bank loans and extension of maturities have an important role to play in crisis prevention and debt management. Therefore, striking balance between new resources (which should be emphasized more), breathing space, debt restructuring and debt relief as appropriate by all creditors is urgent and critical. On the review of the existing DSF, the focus should be placed more on creating space for developing countries to borrow more without worsening their positions any further.

Summary of presentations

The panelists agreed that the present mechanisms are not adequate to deal with the present situations surrounding debt issues and to respond to the pressing needs of low income countries.

debt sustainability negotiations. To provide more liquidity to developing countries, he proposed debt-service “rationalization” as ethical solution, which, according to him, also reflects a lesson learned from the past crises.

Mr. Raffer drew attention to already existing possibilities of debtor protection, especially breathing space for sovereign debtors, as well as to substantial progress achieved since 1982. He showed that proper insolvency procedures on sovereign debts are still missing, stressing that sovereign debt management continues to be creditor driven, although creditors must not be judge in their own cause. Citing the former UN Secretary-General on the need to balance the interests of creditors and sovereign debtors fairly, and the Doha Declaration, he stressed the importance of recognizing debtors as a party at the same level as and equal to creditors. Regarding breathing space, he quoted from the Articles of Agreement of the IMF, the IBRD and IDA. The IMF’s statutes stipulate capital controls as a membership right that can be implemented unilaterally. Members may not use the Fund's general resources to meet a large or sustained outflow of capital (as done during the Asian Crisis 1997-8 in open violation of statutes). Members of the IBRD and IDA have the right to apply for a relaxation of the conditions of payment. Even domestic currency may be used temporarily to service debts. Both international financial institutions (IFIs) must take such member’s interest into account when deciding on relaxation. He pointed out that statutory obligations contrast sharply from the conditions imposed on debtor countries so far. Tackling the topical question of private creditors expected to implement Paris Club debt reduction decisions, he stressed that these creditors are not even heard and that their basic rights are routinely and gravely violated. The hold-out problem arises from the refusal of the Paris Club to honor the Rule of Law by accepting proper insolvency proce these countries are much worse than what has been projected by IMF. She expected that challenges faced by these countries would be greater than ever before. By making distinctions between debt standstills and debt moratorium, she explained that the debt moratorium proposed by UNCTAD is a type of debt relief, in which interest and principal are either written off or deferred or recapitalized. She argued that debt moratorium is beneficial for both creditors and debtors. In reference to past examples of debt moratoriums promptly adopted in response to a natural disaster or financial crisis, she reiterated its benefits to distressed countries, provided there is political will. She stressed the suitability of the temporary debt moratorium to the current economic conditions and called for support on the UNCTAD proposal from the international community and creditors. As in the case of previous panelists, she recalled the lack of appropriate international debt resolution mechanisms. She proposed for setting up a permanent and transparent mechanism for stabilizing economic situations and predicting crisis. She concluded that, to avoid future debt crisis, scaling up official development assistance, increasing confessional lending and support from the international community are must, in addition to the temporary debt moratorium.

Mr. Kamel presented his country's experiences on debt swap programs for development. Among the four debt swap programs (known as "debt4development" or "swap4development") that had taken place since 1994, his presentation focused on the Italian-Egyptian Debt Swap (IEDS) Program, which started in 2001 and concluded in 2008. Under this Program, an eligible portion of official bilateral debt owned by Egypt to Italy was converted into financial resources to implement 53 development projects in the areas of environment and information and communication technologies (ICT). Though the scale of the IEDS Program was marginal relative to the country's total external debt, it was considered as successful in terms of achieving desired positive impacts on targeted beneficiaries. He stressed the importance of making joint decisions by the debtor and the creditor in the selection of projects, modes and frequency of monitoring process and modes of interventions. The active engagement of all stakeholders (including the private sector and civil society) was also the key. He considered that identification of priority areas or sectors was one of the key success factors by examining regional diversities and aiming to narrow gaps within the country in line with the country's overall development strategy. He also highlighted human development or building local capacity, equally distributed within the country, as the key for this Program as well as achieving development goals in general. The Program was designed and divided into eight clusters matching the MDGs (i.e. environment and cleaner industrial production; better management of water resources; rural development and promotion of agricultural exports; poverty alleviation and improving the quality of life; youth and children; health; women development and empowerment; and ICT). A long list of lessons and recommendations was produced after evaluating the outcomes of this Program using the Paris Declaration Indicators and the MDGs. Given the availability of limited resources, focusing on a small number of projects is critical to yield maximum benefits. He concluded that using debt swaps to achieve development goals is feasible and effective and that the country's experience can be replicated or adopted in other developing countries. The second phase of IEDS was implemented in 2007 and expected to be completed in 2011.

In his presentation, Mr. Kargman noted the need for a new sovereign debt restructuring mechanism and said that the need for new approaches in this area has become even more important at a time of financial crisis. He then outlined the details of a proposal that Professor Christoph Paulus (Humboldt University, Berlin) and he have developed for the establishment of an independent international arbitration tribunal – a Sovereign Debt Tribunal – for the resolution of sovereign debt restructuring disputes. The proposed tribunal would be an independent, standing body and would have experts in sovereign finance and related matters serving as its arbitrators. The parties to any sovereign debt financing – the sovereign and the lenders – could agree in the relevant financing documentation to resolve any restructuring disputes through resort to the proposed Sovereign Debt Tribunal. They could also specify the types of issues – ranging from narrow issues such as verification of claims to broader issues such as debt sustainability and feasibility of proposed restructuring plans – that the tribunal would be empowered to arbitrate. Mr. Kargman further noted some of the primary attributes of the proposed Sovereign Debt Tribunal: expertise, independence, neutrality, certainty or predictability and volition of the parties. He indicated that the proposal for a Sovereign Debt Tribunal has been a project of the International Insolvency Institute, an organization of leading international insolvency professionals from around the world, and that the proposal has been endorsed by the Institute's membership. Separately, Mr. Kargman briefly discussed a different project of the International Insolvency Institute dealing with “extraordinary restructuring solutions” that are designed to address the fallout from the global financial crisis on the real economy of nations. He indicated that this project is considering how in the wake of the financial crisis, there may be a need for quicker restructuring responses than may be provided by conventional restructuring approaches such as traditional in-court and out-of-court restructurings. In particular, the project is focusing, among other things, on how bridge or interim financing for restructurings can be mobilized quickly and potentially on a large scale, how the necessary restructuring and turnaround expertise can be deployed, and how expedited restructuring procedures can be made even more effective.

Summary of discussions

Focus should be shifted to address fundamental problems

It was recognized that the policy options proposed in this consultation (such as debt moratorium) are not part of the ongoing negotiations on DSF or debt restructuring mechanisms. For example, considering the fact that new loans from IFIs are making more countries indebted, a proper balance of new resources, standstills, debt relief, debt restructuring and debt for development should be discussed more at the international level. Questions on governance factor in DSF and the ratios used for assessing debt sustainability should be put on the table.

Voice of HIPCs and low-income countries should be reflected

A participant requested for clarification on Mr. Khor’s remark on the review of DSF that took place at the BWI’s annual meetings in Istanbul in which developing countries’ voices were not taken into account, despite the presence of ministers from developing countries. The panelists explained that the review process of the DSF at these meetings was prepared and presented by the staff members of the BWIs, rather than by debt managers of the relevant developing countries Ms. Li criticized the existing DSA as a closed process.

Second opinion to the BWIs

Some expected that the UN system should play a role as a second opinion to the BWIs to improve global debt monitoring and surveillance.

Precautionary reserves accumulated by the BWIs

A participant argued that, instead of criticizing IFIs' lending practices, the focus of reforms should be placed on comparable treatments of debtors and creditors. Mr. Raffer stated that, as in the case of private creditors, IMF applies high spreads to its lending as default risk premiums and builds up its loan loss reserves. Giving all available resources to the IMF alone does not seem to be right. The Chair reaffirmed the existence of the loan loss reserve account (or now known as "precautionary reserve") of both the IMF and the World Bank which have not been utilized for the HIPC initiative

An independent international debt resolution mechanism

Mr. Raffer reiterated his view on IFIs' public obligations and their double standards, which do not foster development and rather harm a large number of poor countries. For example, in his view, sovereign debt restructuring mechanism (SDRM) clearly lacks independence due to its association with IMF. He emphasized the importance of creating a truly independent institution to deal with sovereign debt restructuring and resolutions. In response to the question on how the ruling of tribunals or arbitrations can be binding, Mr. Kargman responded that there was putting the arbitration clause in a debt instrument may be the first step and that a sovereign debtor's failure to comply with the ruling may adversely impact on its future borrowings.

Debt swap for development as a policy tool for debt restructuring

"Debt4development" is one option for developing countries, but how to negotiate creditors to reach agreements may be a challenge for low-income countries with high debt volumes and low institutional capacity to follow the positive Egyptian experience. Mr. Kamel highlighted the importance of political will and strong leadership on debt restructuring in terms of both designing and implementing innovative solutions. In the case of Egypt, the intention was there with right people at the right time but enough knowledge was not there at the beginning, which seemed to be developed and accumulated during the course of the Program. Ms. Schneider mentioned Indonesia as another country that has successful experiences to reduce debts by adopting this m statutes (e.g. reducing debt obligations in the case of default, but, in practice, IFIs do not recognize a country is in default as long as such country maintains “mutually respectful contacts” with IFIs), any reforms would be meaningless. Ms. Schneider stressed that the sequence of reform is not important and that both BWIs and DSF should be reviewed and reformed simultaneously as needed. Ms. Li stressed the need of developing countries for new resources with less conditionality and pro-cyclicality. She called for the crisis management in parallel with the systemic reforms. She expected that the current crisis may become the best opportunity to push forward the reforms of BWIs.