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Resolving Debt Crises: How a Debt Resolution Mechanism Would Work

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The issue of foreign debt has made a major comeback. This is due to the crisis in Europe, in which many countries had to seek big bailouts to keep them from defaulting on their loan payments.

Before this, debt crises have been associated with African and Latin American countries. In 1997-99, three East Asian countries also joined the indebted countries' club.

Last year, European countries, notably Germany, insisted that private creditors share the burden of resolving the Greek crisis. They had to take a "haircut" of about half, meaning that they would be repaid only half the amount they were owed.

It is increasingly realised that bailouts, where new loans are given to indebted countries in order to enable them to keep up to date with paying their old loans in full, are not enough and may be counter-productive, when the countries are facing a problem of insolvency and not just temporary lack of liquidity.

The restructuring of some Greek debt that was owed to private creditors is an example of what needs to be done.

However, the ad hoc restructuring undertaken in the case of Greece is not enough. There needs to be a more systematic framework available to countries on the verge of debt default to conduct a proper debt workout, with principles agreed to internationally.

In the absence of this, unilateral debt restructuring will probably be messy, as when a country is forced by desperate circumstances to declare a default and propose its own debt restructuring, which may or may not succeed in getting its creditors to agree to the terms.

Even if a majority of creditors agree to take the "haircut" proposed (for example that 30 or 50 cents of every dollar of the debt is repaid), a minority may hold out against the restructuring and this may disrupt the whole exercise.

The current court case taken by a "vulture fund" that is holding out against Argentina's debt restructuring is a clear example.

Though the debt crisis now has Europe as its epicentre, many developing countries may soon also be facing the same predicament.

Due to the effects of the global economic slowdown, with export prices and earnings beginning to take a significant hit, many developing countries are becoming vulnerable to a debt crisis. An increasing number have dwindling foreign reserves that can only pay for less than three months of the value of their imports.

Recognising the widening global crisis of debt, the United Nations General Assembly held a special event in October 2012 on **Sovereign debt crises and restructurings: Lessons learnt and proposals for debt resolution mechanisms**.

As one of the speakers, I noted that there was a real need for an internationally-coordinated system of debt workout. There are many weaknesses in the present situation of voluntary systems such as including an element of burden sharing in collective action clauses in loan agreements, or in unilateral workouts that countries seek.

These voluntary methods may be either inadequate or messy and unpredictable in design and effect as they do not have the benefit of an internationally agreed system. There should thus be new efforts to find an international solution such as a statutory debt workout mechanism.

The features of such an international sovereign debt workout system have been analysed by the United Nations Conference on Trade and Development (UNCTAD) in the past three decades. Even the International Monetary Fund (IMF) secretariat came up with a proposal for a sovereign debt restructuring mechanism some years ago, but it faced opposition from some countries and faded away.

The pioneering UNCTAD model is mainly based on the principles of the US bankruptcy law, especially Chapter 11 on private sector loans and Chapter 9 on the public sector, covering municipalities. The principles from this law can be applied to countries in an international level statutory debt workout mechanism. The elements of such a system are as follows.

First, a country facing debt difficulties can declare a temporary standstill on its external debt servicing. This gives a breathing space for the country to formulate a proper debt servicing plan.

The plan should cover all debt servicing, whether the difficulty is due to solvency problems, in which the debt has to be reduced, or liquidity problems, in which case the debt has to be rolled over.

Second, there is an automatic stay on litigation by creditors during the standstill. This is to avoid problems to both

debtor country and its creditors. The stay on litigation is to prevent a situation where many creditors are scrambling for an exit or lining up to sue the country.

This is similar to a feature of the WTO rules, in which a country facing a serious balance of payments difficulty can unilaterally suspend its tariff obligations in the WTO and will not be subjected to legal action by other WTO Member States.

Third, an independent panel of legal and economic experts would be established to address the issues arising from the standstill, including assessing the countries' debt situation. The independence of the panel is important, in that creditors should not be on the panel as they have a direct interest in the case. IMF itself is a creditor, and so cannot be on a panel to avoid conflict of interest.

Fourth, the country undertaking a temporary standstill would have to also undertake selective capital controls to prevent capital flight that can result from the standstill on debt payments.

Fifth, new loans should be provided to the debtor country, in a situation known as lending into arrears, in order that the country can continue to implement policies for economic and social development. The new loans should be specifically to enable countries to continue its trade, and in particular to be able to import essential items. But they should not go into financing debt payments, as this issue is to be discussed in the debt workout mechanism and through the debt restructuring. If the new money is going to the debtor who uses it to pay back old creditors, the point of the exercise is lost. The new loans should also not go towards financing capital flight.

Sixth, the new loans contracted after the standstill should be given seniority status. This is to facilitate the emergence of new creditors and new loans.

Seventh is the debt restructuring exercise. The debt workout can include the rollover of existing loans, especially if the problem is only a liquidity problem; and partial debt write-down or write-off if it is a solvency problem. The terms should be the result of negotiations between the debtor country and creditors. In the negotiations, the operationalizing of the Collective Action Clauses, where they exist, could be a part of the exercise. Therefore there can be a combination of voluntary CACs and statutory debt workout. If creditors and the debtor country cannot reach agreement, then they can seek arbitration through an Independent Arbitration Panel.

The above have been proposed by UNCTAD over the years. Elements of this were in the Sovereign Debt Restructuring Mechanism (SDRM) proposal by the IMF secretariat which took on several of these features. The IMF Board in 2000 endorsed the principle that a debtor country can impose a unilateral debt standstill as well as that it may need to impose capital controls simultaneously.

South Korea, in a statement at a G20 meeting, said: "Many who have analyzed Korea's 1997 and 1998 crises have found that Korea could have solved its liquidity problem sooner had a standstill programme been in place at the time Korea requested IMF assistance at the end of 1997".

During the euro crisis, several analysts and quite a few political leaders have proposed a debt restructuring exercise which would be more effective than the process of "muddling through" which has been taking place.

The UN is well placed to take the lead in this whole exercise of establishing a statutory debt workout mechanism.

This conclusion was also made at the special UN event by several other speakers, including the UNCTAD Secretary General Dr Supachai, Harvard professor Kenneth Rogoff, the Vice Minister of Development of Norway and the Finance Secretary of Argentina.

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