Workgroup on Solidarity Socio-Economy - Alliance 21
Workshop on International Regulations

# A new International Financial Architecture

**with an International Board of Arbitration for Sovereign Debt:**

## A proposal

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**Background**

The 1970's was a time of cheap money and loan pushing. The effective interest rate average was –3.7% which fed economic growth world wide at a time when an economic contraction should have happened as a result of the increased price of energy and the oil crisis. Developing nations borrowed because: 1) they had oil and could afford it, 2) because they did not have oil and had to cover a massive deficit. Lenders, public and private, recirculated the new petrodollars with no international supervision, allowing for massive bank overextensions, while debtor nations held uncontrolled budget and balance of payments deficits around the world. There was the mistaken perception that financial flows would be permanent.

In the late 70's the real interest rate started to increase as stagflation began to be felt. Eventually, in 1981, Reaganomics was introduced to reactivate the US economy and pushed up the real interest rates immediately from the negative average to +17.7% (1981) and 26% (1982) (Bianchi: 1987). All debtor nations with a primary exports base, entered defaults from 1982 onwards when together with the rise in interest rates, commodities prices collapsed, and net resource transfers became negative. From then on, in a never continuous motion, debtor refinanced the payments of the past year making them repayable in the following eight years.

Between 1982 and 1989 reschedulings were done yearly while flows remained negative and incomes dropped sharply in Africa and Latin America. Throughout Governments were pressed by the IMF to pay up and follow their policies leading to high, and very high after the adjustment programmes were introduced and tightened. The IMF was the guarantor of sound economic policies and in that name the Governments had to comply in order to return the next round of debt negotiations at the Club of Paris and the London Club.

These resulted progressively on better terms offered to the debtors, the creation of the categorization and concept of highly indebted poor countries and medium income highly indebted countries. For HIPCs, special treatments were created before the World Bank mechanism as it exists, today was designed. The Toronto terms, 1988, Naples terms, Lyon terms (previous to HIPC which came into being in 1996) and Cologne terms (just previous to enhanced HIPC 1999), to no avail. The result was the creation of HIPC which had no results and after Cologne Enhanced HIPCs, with little success as will be seen below.

The basis for this work is " A favor de un tribunal internacional de arbitraje de deuda soberana" Cuadernos de Discucion, America Latina en la Economia mundial, U de Cuenca, Ecuador, 2004. The author is thankful for the comments made by Professor Kunnibert Raffer from the university of Vienna on the full preliminary Spanish version. Discussion held with Professor Mac Fadden in Havana at the Conference on Globalization and Development, January, 2004, was extremely enlightening.

For highly indebted medium income countries such as those in Latin American and the Philippines two initiatives were created to debt with private creditors: The Baker Plan, launched in 1985 in the wake of the Garcia 10% policy in Peru and the Brady Plan launched in 1989 in the wake of the failure of the Baker Plan. The result was the conversion on of debts from Floating rate notes to bonds with a substantial debt reduction.

The changes in the global economy have turned the debt payments agreed very difficult to meet and bonds are not subject to refinancing. Market mechanisms are recommended issuing new bonds to buy back old bonds, thus increasing the NPV of the debts as country risks have risen after the world economy turnaround of 1998.

**The existing international financial architecture**

The old international financial architecture (IFA) became obsolete for all practical purposes then, but the role of the IMF as guarantor of sound economic policies finished in Argentina in 2001 after a long period of debate on its performance in Asia (Stiglitz: 2000). The IFA was designed for a stable world with fixed parities, which ended in 1971 and needs to be reconsidered after the definitive solutions sought during the 1990's seem to have failed. Global institutions for a global world are required.

The IMF/World Bank and their crossed conditionality have turned into political parties that exports policies, accompanied by resources and economists around the world, without any far reaching results for the developing nations. Mistaken projects, or policies bear no cost to these institutions nor to their professionals while those policies place the governance of the developing nations at stake.

The only economy that has grown for over a quarter of a century at the 9% range average, with stability while all others have undergone large swings, is China, not an IMF/WB member and not subject their conditions and policies. It is not a borrower of any significance. By contrast with Africa and Latin America, the failure of these institutions and their policies is undeniable.

**Ecological debt**

Martinez Alier in a Heinrich Böll Foundation Seminar in Cochabamba Bolivia, June, 1999, coined the concept of ecological debt as that created by richer countries that use up oxygen, water and global public goods for free, to the detriment of the lesser developed countries. Mineral and oil extraction pollutes the area were the mineral or oil is extracted. At the same time, the ecological terms of exchange are that a clean high tech good produced in the North, is paid in these. For example, a mobile phone (120 US$) costs in copper (at 1.10 us cents the lb is 109 pounds, roughly 50 kg.) A basic laptop (800 US$) placed in oil means we extract end export 20 tons (at the 40US$ price) The idea is that the more developed economies pollute more and are responsible for the deterioration of the earth, weather, the ozone layer, and with it, the global conditions.

The countries which have raw materials, water, forests, etc are in the South mostly and a debt is established that must be rapid. The warm up effect that is melting the snows of the Andes and threatens the Amazonia, the ozone hole that affects parts of Africa and South America result from irresponsible consumption patterns in the North that must pay their ecological creditors in the South their debt. The issue has not advanced as the needed valuation of international public goods (mountains, water, weather oxygen, etc) does not yet exist.

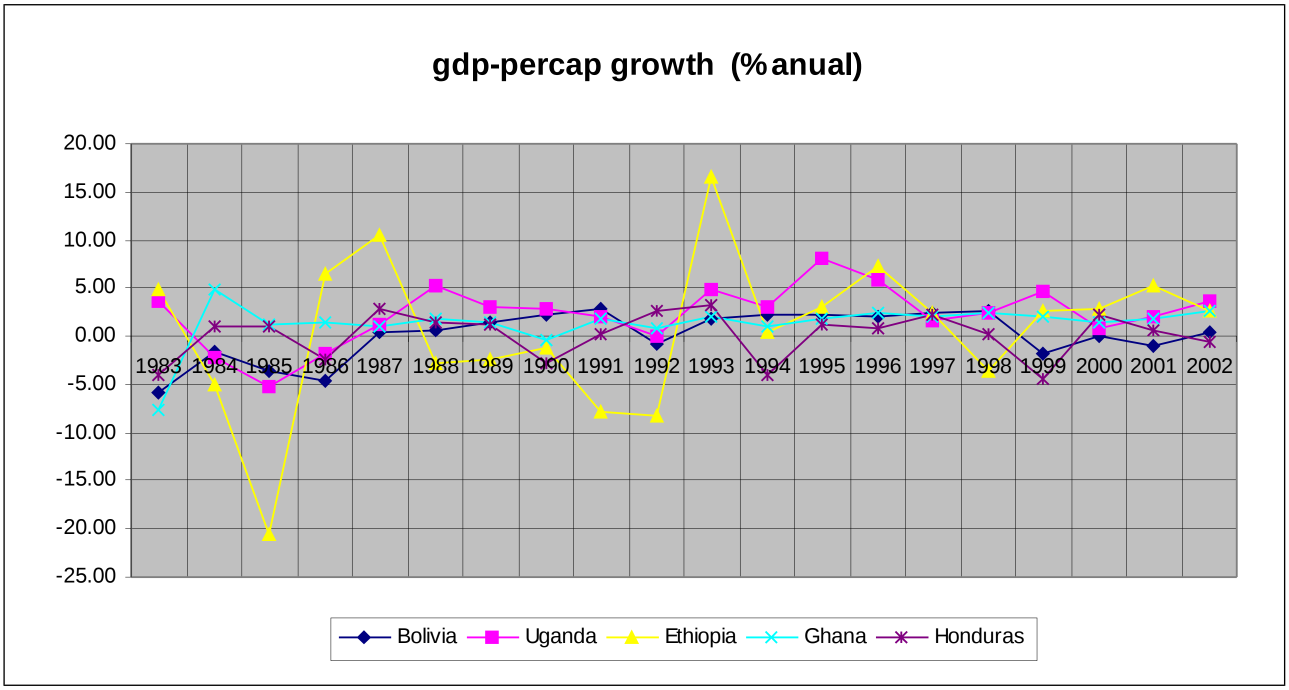
**HIPC and PRSP at a glance: IMF/WB hard to kill**

The domestic crises of the African, Latin American and some Asian nations produced by the debt crisis of the early 1980's was man made through the rise in US real interest rates from an average of –3.24% during the 1970's to 26% in 1982. Debtors had no protection having loans denominated in variable rates against such an abusive change in international circumstance. The poorest nations of the world became poorer at that time. While Latin America exported its domestic savings, Africa exported its survival capacity.

The international outcry led to the creation of the HIPC initiative in 1996 and the Enhanced HIPC in 1999. The IMF is perceived as responsible for increased poverty around the globe which led to their creation of a Poverty Reduction Strategy Paper in 2000, placing the monetary institution in charge of balance of payments equilibrium in the development field. Debtors had no influence in the design of these (WB:OED: xix) in spite of being responsible for the agreed programmes. Essentially there are conditions to reach the completion point of the application of the policies required (3 years) and other policies to reach the decision point to reduce the debt (3 added years). According to the World Bank OED, a necessary condition for the programmes to work is the adoption of sound macro economic policy framework. The debtor nations weaknesses in administering their programmes seems to be a problem and the rigidities in the use of funds towards the social sectors may create budget distortions (OED: Prologue).

The diagnosis is that a one time debt reduction is not a solution as the structural roots which led to the imbalance and the debt may reappear. Currently there are six countries that have reached the completion point and are subject to debt reduction schemes and 20 countries that have reached the decision point (data to July 2002 published Jan 2004)). To reach the decision point a three year track record of macroeconomic stability and policy reform is required plus a PRSP with the IMF. To reach the completion point, a further 3 year track record of macroeconomic stability and policy reform plus completion of the PRSP plus one year PRSP implementation plus the achievement of performance benchmarks for structural and social reforms.

Bolivia is a success story, it reached the completion point after six years of following the policies and as the graph shows, its economic growth is negative from 1998 on and its governance problems have made it a basket case. Honduras, not shown, follows the same pattern. Uganda, which also reached the completion point has small positive growth.




The result is shown in per capita terms below:

**GDP per capita in 1995 Dollars (random countries)**

| | | 1982 | 1990 | 1998 | 2002 |
|---|---|---|---|---|---|
| **Completion** | Bolivia | 935 | 836 | 972 | 947 |
| **Completion** | Uganda | 236 | 251 | 330 | 367 |
| **Decisión** | Ethiopia | 115 | 100 | 108 | 124 |
| **Decisión** | Ghana | 335 | 346 | 399 | 432 |
| **Decisión** | Honduras | 696 | 683 | 727 | 711 |

Source: Word Bank World Development Indicators

After six years of dry adjustment and changes in the economic administration of the economy with little external finance, then debt reduction is introduced. In Bolivia it has led to a reduction in income, in Uganda to a rise, and these have been benefitted with debt reductions. The countries undergoing programmes to reach the decision point have mixed results: one has a reduction in income, and two have improvements. With extreme poverty in some of these countries at catastrophic levels and no redistribution policies (these were not considered at the Washington Consensus because there was no consensus, says Willilamson:2003), horrendous political and social indicators it might be the case that the design of the economic policies is removed from the reality of the country. The “one size fits all” (except extra large G7) does not function. Sovereign debtor policy design is required for policies that must be seen in the perspective of long term development goals and not short term adjustment. Six years of adjustment is not short term.

The failure of the IMF has led it to have three managing directors since the year 2000. The failure of the WB is less obvious although the lack of results is a shared product given the crossed conditions. What have failed are the negotiating mechanisms, terms and conditions designed.

**The proposed new architecture**:

A new international financial architecture is required and it must include a new set of rules and institutions:

1) A universal legal code that will make sure all creditors have the same rights and all debtors the same duties, with the same enforcement mechanisms. This is analogous to what has occurred with international trade law in a process led by a UN commission called United Nations Commission on International Trade Law. (UNCITRAL) Currently international loans are signed using domestic laws of the US and UK.

2) It is clear that these problems recur, an *International Board of Arbitration for Sovereign Debt* is required as a new forum for negotiations instead of the Club of Paris and London Club. It should have a small secretariat as a part of the UN system as an international body that will function regularly and used by UN member countries.

3) The IBASD Secretariat will recommend arbiters that will be selected by creditors and debtors in even proportions with the presidency decided by both sides in order to have an uneven number of board members. The inspiration of the IBASD lies in what was proposed for the German debt agreement of 1952. (Hersel, 1998)

4) Collective Action clauses must be incorporated into all new instruments in order for the recommendations that follow to operate. These consists of clauses wherevy a majority of bondholders represent all, using the Mexican precedent.[1]

**The Object of IBASD**

The object of the IBASD is to ensure stable economic growth in the debtor countries and that the costs of international instability are shared evenly by all creditors and debtors, unlike what happened during the 1980's.

Procedures for the use of such a mechanism should begin in two different scenarios:

A) Crisis prevention: When the ministry of finance of the debtor country foresees that debt payments will substantially restrict growth given some external factor (massive interest rate increase, raw materials price contraction, or some unforeseen international circumstance that affects

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[1] **CRITICA GRUPO DE ACREEDORES CLÁUSULAS DE BONO MEXICANO,** *Excelsior*, México D.F., Miércoles 26 de Febrero de 2003, Finanzas, 1F y 6F.

*Reduce Posición de Negociación en Caso de un Incumplimiento*

NUEVA YORK, 25 de febrero (Reuters). – El plan de México para emitir bonos con una nueva cláusula diseñada para facilitar su reestructuración recibió críticas el martes de un grupo de acreedores de mercados emergentes, que aseguraron que el mecanismo reduciría su posición de negociación en caso de un incumplimiento. México ha propuesto un bono global por 1,000 millones de dólares, que incluiría la llamada Cláusula de Acción Colectiva (CAC), la cuál permitiría modificar los términos con menos de ciento por ciento de la aprobación de los tenedores, probablemente con 75%, the domestic economy (e.g. the massive devaluation of a major trading partner or a net resource transfer turnaround)).

B) Crisis resolution: The debtor nation over borrowed or resulted in an overhang which surfaces because there is a bunching of maturities or due to some unforeseen circumstance. ( e.g. massive adverse capital movements that generate a devaluation) or any other unforeseen and unpreventable circumstance it is incapable of paying. ( many African nations as a result of the erosion of their income base and a massive growth of debt due to capitalization of interest)

The difference between both approaches is that in the first and preferable case, the debtor country will not suffer a setback due to a debt crisis, if the negotiation is done ahead enough from the foreseen large fall in export income, tax income or GDP.

In the second case it will be damage control, similar to what HIPC tries to do with little success. The IBASD may opt between debt refinancing and an entire rescheduling of the debt and must have the prerogatives to recommend one time debt stock reductions from all creditors. From the evidence of the 1980's, continuous refinancings increase the cost of the debt unnecessarily giving the bankers an additional rent at the cost of depressed economies. The reason for this rent is that in every refinancing, unpaid interest is capitalized and the commissions are charged on the entire amount. If this is done once a year, the debt increases exponentially, particularly if international interest rates are high, which is normally the reason why the debt crisis comes to a head in the first place.

**No creditor discrimination and free riders**

From the debtor side, no creditor may be exempt from participating at the board. Currently preferential creditors take advantage of the concessions provided by other creditors as debt agreements at the Club of Paris and London Club makes them more capable of recovering their loans. The argument that multilaterals fund themselves in the bond market does not make their country risk different from that taken by ordinary bondholders, except that they have more detailed information and because of that should have less risk. With HIPC they have entered the debt reduction scheme in a fractional way.

**The standstill and debtor protection**

A standstill request from all creditors until the debt payment problem is solved, should be the Secretariat first action taken at the time of the presentation of the case at the IBASD window. At the same time, debtor protection in suit with that provided by Chapter 9 (Raffer:1990,2002,2003) should be sought by the Secretariat in the name of the debtor and should last the same time as the standstill.

**The payback conditions**

The social and economic conditions placed for the rescheduling or refinancing of the debt, as the case may be, must be based on the principles of the Economic, Social and Cultural Rights charter ensuring that the goals are met in order to continue receiving the benefits of the new payback calendar. Development is the only way out of a debt stranglehold and investing in more and better education, broader health services, projects for the poor, etc, as well as increased investment in infrastructure are a part of this. Redistribution policies are necessary to alleviate extreme poverty. Debt payments must not mean that the population lose its wage levels and that the people end up paying the rich nations more than they ever received, as what we saw happen during the 1980’s and part of the 90’s. Debt payments, must not mean that domestic savings are exported introducing a depression into the domestic economy or policies. On the other hand, ESCR quantifiable goals make sure that both populism and the temptation of managing public expenditure without any control ( e.g. the purchase of presidential aircraft and other such) happen. Conditions are required to put in leash public expenditure. The question is what conditions, who puts them and how are they monitored.

**Corruption**

Given the African, Asian and Latin American experience with internationally related corruption, the IBASD must evaluate the quality of the loans, independently, and set aside those with a corrupt background in order to seek the invalidation of the contract, if the case may be, and/or to recommend a penal procedure against those responsible, if it was not yet done. The problems with this is crime prescription given some loans from the 1970’s may be too old to be considered for penal procedures. The implication here is that the International Penal Court should be extended to cases of international corruption using the new international agreements on corruption signed in Vienna and Seul 2002 and 2003.

Finally, the nature of the current world crisis, the uncertainties created and the need for new proposals for a global world require new institutions. An international board of arbitration for sovereign debts is kingpin for the new more democratic international financial architecture and for a more stable world economy. A new world is possible.

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