INTERNATIONAL POLICY ANALYSIS

Making the Global Financial System More Resilient

A Regional/Group-wise Approach to Sovereign Debt Workouts

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- More countries in the Global South are heading towards a new debt crisis due to low global interest rates and low commodity prices. Thus far, there have been no innovative approaches for a possible debt workout with regard to the new crisis.

- Regarding the next crisis, there is something to learn from the HIPC/MDRI initiatives of the 1990s and 2000s: overcoming political deadlocks by designing debt relief exclusively for a limited group of countries.

- Such a limited debt relief scheme could then imply procedural innovation that could remedy weaknesses of the HIPC/MDRI schemes and debt restructuring mechanisms at large, by making them more comprehensive and impartial.

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1. The Next Sovereign Debt Crisis: A Global Problem with Differentiated Characteristics

Since 2005, the Multilateral Debt Relief Initiative (MDRI) has concluded in large part the debt relief process for the poorest countries, which started under the aegis of the International Monetary Fund (IMF) and World Bank with the first Heavily Indebted Poor Countries (HIPC) Initiative in 1996. External debt owed to commercial, bilateral official, and multilateral creditors was substantially reduced and debt indicators of the poorest countries decreased dramatically. Most of the middle-income and »emerging market« countries in debt distress had achieved some external debt relief — albeit less dramatic — a few years earlier under the Brady Plan, which reduced their exposure to their private creditors only.

Policymakers were tempted to consider sovereign debt crises — of the type that occurred after Mexico's default in 1982 — to be a thing of the past. Logically, it is undeniable that individual debt relief operations can never rule out future over-indebtedness. Politically, however, global debt problems were treated in this manner during much of the financing for development discourse. It was too tempting for policymakers, such as the G8, to look instead at development finance from the positive angle of resource mobilization, ignoring that debts are the inevitable downside of any loan flowing into the Global South or the European periphery. The 2030 investment agenda, the German G20 Presidency's »Compact with Africa«,[1] and even a veritable »Marshall Plan for Africa« propagated by the German Development Ministry are the most recent expressions of this one-sided understanding of capital flows into infrastructure and other economic development projects. Some even take the form of mega-projects, such as the Chinese »One Belt, One Road« initiative.[2]

In reality, the global financial crisis of 2007/2008 and the subsequent sovereign debt crisis in the European periphery had already caused the hard awakening: a persistent risk, such as debtor-creditor imbalances, requires a structural response that addresses crises whenever they occur.

Regarding the beneficiaries of the debt relief efforts of the 1990s — i. e. low- and middle-income debtor countries in Asia, Africa, Latin America, and the European periphery — indicators did indeed start to rise again from 2009 onward. And that rise became increasingly dynamic. Based on figures from World Bank's *International Debt Statistics* database,[3] the annual analysis at erlassjahr.de showed 83 countries with one, several, or all indicators in critical ranges for end-2013, and the latest available data for end-2015 show a rise to 116 countries.[4] Even beyond the present data, the trend is all too clear: for every two improved debt indicators between 2011 and 2015, there were seven that had worsened by at least 10 per cent; one year earlier, i. e. for the 2010–2014, period this relationship had been 1:2.

There can be no doubt that many more countries are heading for a new sovereign debt crisis, and if we look at the global economic conditions under which this crisis emerges, we see stunning parallels to the build-up of sovereign over-indebtedness ahead of Mexico's 1982 default: extremely low interest rates in the advanced economies (caused by the ultra-liberal monetary policies of central banks and the capital oversupply due to rising oil prices and recycled petro-dollars), combined with a slump in global commodity prices (caused by a reduction of global demand, which leads to drastic reductions in hard currency incomes of commodity exporters). Political circumstances also show increasing parallels: in the past, many military and authoritarian governments in debtor countries provided the loan pushers of the time with a seemingly stable environment, which would guarantee repayments regardless of the social costs, which an unsustainable debt service might cause. Today, we see that the wave of democratization of the 1990s has been exhausted and is giving way to more and more autocratic and authoritarian regimes in debtor countries. On global capital markets, this again encourages capital transfers without too much emphasis on due diligence on the

1. F. Mabera / N. Monkam (2017): Germany's G20 Presidency and the Africa compact: what now for the G20 Africa partnership? available at: http://blogs.die-gdi.de/2017/01/31/germanys-g20-presidency-and-the-africa-compact-what-now-for-the-g20-africa-partnership/ (last accessed on 14.3.2017).

2. For a short description see: T. Jianchen (2016): ›One Belt and One Road‹. Connecting China and the World (July 2016); available at: http://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/one-belt-and-one-road-connecting-china-and-the-world (last accessed on 14.3.2017).

3. World Bank: International Debt Statistics 2017; available at: http://data.worldbank.org/data-catalog/international-debt-statistics (last accessed on 12.3.2017).

4. erlassjahr.de / Misereor (2017): Schuldenreport 2017; English: Sovereign Debt Monitor 2017.

creditor side.[5] Rather, the confidence, which prevailed in the 1980s that »states do not go bankrupt« is once again driving creditor behaviour.

What is new, however, is that the debt relief operations under HIPC/MDRI have indeed provided fiscal space for meaningful infrastructure investment through external loans or bond financing. Nevertheless, the distinction between meaningful investment and corrupted white elephants, as well as between sustainable and unsustainable debt, is as difficult to make now as it was 20 years ago.[6]

There are further novelties in the crisis currently emerging:
- the broad-based shift from loan to bond financing on the private lender side;
- the relative rise of domestic public debt;
- the growth of private (as opposed to public and publicly guaranteed) external debt.

Compared to the last crisis, these three novelties tend to make a meaningful debt workout process even more complex than it was when the HIPC initiative was designed.

2. Shortcomings of the Global Sovereign Debt Workout Regime in the Face of the Next Crisis

Even before Mexico's default in 1982, there were calls for the establishment of a quick and comprehensive debt workout process. People who raised it foresaw that a protracted and piecemeal back-and-forth negotiation process over debt restructuring and eventually debt relief with ongoing enforced payments from insolvent sovereigns, in fact would ultimately be more expensive for everybody.[7] For instance, the debt of the 36 countries, which ever since have obtained HIPC debt relief, stood at 78.8 billion US dollars in 1982. Despite some piecemeal debt and debt service relief through the various frameworks of the Paris Club, that debt rose to 118.5 billion US dollars in 1997 at the onset of the HIPC-I initiative. The up to 90 per cent debt relief, which HIPC/MDRI combined provided, would have implied fewer nominal losses for the creditors — or less relief would have been required in the first place — had it come immediately after Mexico's 1982 default. Additionally, a timely relief of the sort that later came would have saved the affected countries years of harsh and futile austerity. The protracted outflow of resources due to an unsustainable debt service was one of the key elements in bringing about what in retrospect was called the »lost decade« of development. What creditors did with their refusal to provide adequate relief was in fact the equivalent to what we know in domestic private and business law as the statutory offense of »delayed filing of an insolvency«.

However, no one can predict the future, and thus the belief that states would always be able to find the resources to pay off their creditors prevailed, because it spared both sides from making hard and disruptive decisions. The warning voices remained unheard. Denying that debt cancellation for (Southern) sovereigns would actually be feasible was the order of the day. Arguments for such rejection of debt cancellation ranged from obligations of public entities to always honour their legal commitments, through the unwelcome effect of benefitting corrupt regimes in debtor countries, to the threat of a meltdown in the global financial system if one major sovereign default wrecked confidence among creditors, which would then bring all international lending to a halt. In hindsight, we know that the global financial system did not disintegrate when the debt relief for a greater number of over-indebted countries took place. Just, as this had never happened in any of the numerous sovereign debt write-downs in the 19th and 20th centuries.

5. An example of this is the case of Mozambique's »hidden debt«, where between 2014 and 2016 state-owned enterprises managed to obtain more than 2 billion US dollars for largely obscure purposes and under questionable constitutional legitimacy from the Russian VTB-bank and Crédit Suisse respectively. See: J. Hanlon (2016): *Mozambique News Reports and Clippings* #347 (7.12.2016); available at: http://www.open.ac.uk/technology/mozambique/sites/www.open.ac.uk.technology.mozambique/files/files/Mozambique_347-7Dec16_New-ministers_Kroll_repudiate-debt_LAM-bribe.pdf (last accessed 21.3.2017).

6. Identifying emerging crises is no (longer a) privilege of NGOs and human rights defenders. Obviously the IMF is trying to do better in its role as an early warning system than it did 20 years ago, when its notorious debt sustainability analyses served to legitimize whatever Paris Club creditors were prepared to provide in terms of debt relief. These new efforts caused, among others, the present hassle between the institution and European governments over the interpretation of Greece's end-2016 situation, as well as a far more cautious view on debt levels in low- and middle-income countries. See as an example: IMF (2015): Public Debt Vulnerabilities in Low Income Countries: The Evolving Landscape (2.11.2015); available at: https://www.imf.org/external/np/pp/eng/2015/110215.pdf The IMF's position on Greece has been presented most clearly in the IMF blog post by Maurice Obstfeld and Poul Thomsen (2016): The IMF is Not Asking Greece for More Austerity (12.12.2016); available at: https://blogs.imf.org/2016/12/12/the-imf-is-not-asking-greece-for-more-austerity/ (last accessed on 10.3.2017).

7. Most prominent among those were the UNCTAD Trade and Development Report 1986 and the works of the Austrian Economist Kunibert Raffer. See: K. Raffer (1990): Applying Chapter 9 Insolvency to International Debts: An Economically efficient solution with a Human Face, in: *World Development* 18, no. 2 (February): 301ff.

The next chapter will look into some of most important reasons for this protraction, in as much as they are relevant for the design of a better and more efficient debt relief regime in the face of the emerging crisis.

In designing a better framework to deal with future crises, any debt relief operation is based on two distinct, but interlinked decisions:

- the decision to do a debt relief operation at all;
- the decision about its calibration, normally based on a debt sustainability analysis.

As we have seen, the history of the most recent — and in some parts of the world ongoing — debt crises teaches that one fundamental principle has been neglected in the past and needs to be prominently observed in the future, namely that if you need to restructure debt, you need to do it right.[8] »Right« means that relief needs to be designed as too generous rather than too limited, because the damage done by keeping the debtor in a state of unsustainable outflows and consequently in need of further restructuring a few years down the road outweighs potential losses to creditors, through a relief by a few percentage points above the absolute minimum.

In the crucial years between 1982 and 1996, creditors regularly chose the option to »kick the can down the road«[9] and provided only minimal relief, if any. This state of denial was only possible because creditors were entirely in command of global debt relief schemes. How ever sensible, insightful, or selfish they might have been, their decisions shaped the frameworks under which debt relief would be provided or denied. Consequently the various »terms« under which the Paris Club,[10] the most important creditor group of the time, were named after the G7/G8 summit at which they were negotiated and decided upon: Toronto Terms, London Terms, Naples Terms, and finally Cologne Terms. The international financial institutions under their control would design and ultimately implement and even condition the relief based on such frameworks, without any means of intervention by debtors or other creditors — not even from Paris Club members who were not part of the G7/G8 group.

Are we still in the same situation? What has changed since the high time of HIPC, and what could put today's debtor countries into a different position from where they (or others) were 20 years ago? A few — rather technical — elements of debt negotiation processes have indeed changed, but not much, and not always for the better:

- The Paris Club's Evian Terms, which were established in 2004, have abandoned the Club's long-standing principle of equal treatment in exchange for a higher degree of flexibility towards decisions tailored to the needs of individual countries.[11]

- The growing inclusion of various types of Collective Action Clauses into bond contracts can help creditor aggregation and hence collective decision- making within this particular asset class.

On the downside, the changed creditor profiles mentioned in Chapter 1 tend to make consensus building more complex and difficult. Most important, however, is that the power imbalance between the debtor and his creditors has not changed: whatever helpful or useless outcome a debt restructuring will have, largely comes as a decision by the creditors. Moreover, as long as one of the two sides in a norm conflict continues to be judge in its own cause, decisions are not likely to strike a fair deal. Current state practice is a severe violation of one of the most essential principles of the rule of law.

3. Difficulties in Designing a Global Debt Workout Mechanism

Before discussing how this could be changed, we will examine the major motivations for creditors insisting on an arrangement that is such a blatant violation of the principles of the rule of law in most Western countries. Three arguments against a more balanced approach are regularly cited:

8. This principle has been most eloquently displayed by the New York lawyer and debt restructuring expert Lee Buchheit in his open letter to the Finance Minister of the fictive country of Ruritania. L. Buchheit (2011): Open letter to the finance minister of Ruritania, in: *The Banker* (9.2011); available at: http://www.ru.is/kennarar/fmb/store/Buchheit-comment.pdf.

9. C. Reinhart / C. Trebesch (2015): *Sovereign Debt Relief and its Aftermath*. Harvard Faculty Research Working Paper. Cambridge, MA: Harvard Kennedy School: 33.

10. The Paris Club is an informal cartel of mostly OECD member countries, who organize restructurings of their claims on indebted sovereigns collectively. See: www.clubdeparis.org.

11. The Paris Club describes the Evian Approach on its website at http://www.clubdeparis.org/en/communications/page/evian-approach.

a. »This Time is Different«

The title of the groundbreaking book by Carmen Reinhart and Ken Rogoff[12] brings one of the key motivations to the point: as debt sustainability is always subject to estimations about the debtor's economic future, it necessarily implies an element of speculation. This is the rational nucleus of a deeply irrational behaviour on the part of creditors — namely, the assumption that despite the history of repeated debt crises in the past, something is there about the same countries in present times that will prevent history taking a similar course under similar circumstances: low-income African countries reaching positive growth rates after a decade of stagnation, simply because the IMF has prescribed the next programme,[13] Greece raising more than 50 billion Euros from privatisation even when the whole world knows that the country desperately needs cash at any conditions, the tiny Caribbean island of Dominica being told its debt is sustainable even after hurricane Erica has wiped out 93 per cent of its GNI, etc. Such assessments can serve to substantiate the denial of debt relief and thus buy time for creditors to cash in on their claims. On the debtor side the »This time is different« mantra allows governments to continue spending and leave unpopular decisions to their successors. Thus, there are incentives on both sides of an eventual negotiation table to gratefully accept an overly optimistic forecast from Washington, in order to avoid the assumption of responsibility for a possibly critical situation. Moreover, it comes with the welcome side effect of having a scapegoat on whom to blame policy errors that lead to economic catastrophes a few years down the road. Often enough, governments have demonized the IMF as the institution that is to blame for a protracted stagnation through its policy prescription, while at the same time Washington has referred to the notorious bad governance and non-fulfilment of these prescriptions as the major cause for the same evil.

The belief that »this time is different« is hardly ever an explicit but regularly an implicit motivation for creditors to minimize relief as much as possible.[14]

b. Costs

Banks and state agencies do indeed enter difficult territory, when they have to write down claims on bigger sovereign debtors from their books. Debt write-downs are never easy to handle or welcome operations for a creditor. However, any loan is provided with a risk, which is meant to be covered by the interest charged. Moreover, the majority of debtor countries are far too small to endanger a prudent international creditor. For instance, most of the countries that could be part of the regional initiative outlined below are individually — and even collectively — below the threshold of systemic relevance.

However, as elements of uncertainty are necessarily involved, the option of a well-designed process, which allows for debt relief in specific situations under clearly defined conditions and procedures, would be a more cost-efficient option as opposed to one in which the phantom of sovereign solvency is maintained, while everyone knows it is just that: a phantom.[15]

c. Co-ordination Problems

One of the major reasons for the existing debt restructuring regime's inefficiency is its fragmentation into

12. C. Reinhart / K. Rogoff (2009): *This Time Is Different: Eight Centuries of Financial Folly.* Princeton: Princeton University Press.

13. The IMF has gone some way in order to at least acknowledge systematic errors in its forecasts relevant to debt relief. See the IEO study by F. Luna (2014): *IMF forecasts in Program Countries.* IEO Background Paper. Washington, DC: International Monetary Fund; available at: http://www.ieo-imf.org/ieo/files/completedevaluations/BP%2014%2005%20-%20IMF%20Forecasts%20in%20the%20Context%20of%20Program%20Countries%20-%20Luna.pdf (last accessed 17.3.2017). In an important paper published at the 2013 spring meetings, it even seemed for a short moment that the IMF was prepared to rethink the critical role it was playing as a lender and a (monopolistic) provider of debt sustainability analyses: IMF (2013): Sovereign Debt Restructuring — Recent Developments und Implications for the Fund's Legal and Policy Framework. Washington, DC: International Monetary Fund; available at: https://www.imf.org/external/np/pp/eng/2013/042613.pdf (last accessed 17.3.2017). However, the reform dynamic with regard to policy changes has died and given way to a series of merely technical improvements in the IMF's handling of debt sustainability issues.

14. An encouraging sign in this regard has been the most recent Financial Architecture Working Group Report, which the G20 presented ahead of the Baden-Baden Finance Ministers meetings in March 2017. Its diagnosis of existing debt threats is appropriate, when it says, »The G20 underlined in 2016 the risks posed by a possible buildup of sovereign debt in some countries, notably low-income countries, against the backdrop of a sharp drop in commodity prices and tightening in financial conditions …« It then refers to the Addis Ababa Action Agenda as the reference point for dealing with emerging sovereign debt risks. See: *G20 International Financial Architecture Working Group 2017, Co-chairs summary* (Annex 1 Work program and timetable, p. 6); available at: http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Schlaglichter/G20-2016/g20-international-financial-architecture-working-group.pdf?__blob=publicationFile&v=3 (last accessed on 17.4.2017).

15. As an illustration, see a banker's plea for an orderly debt haircut in the extreme case of beleaguered Venezuela. J. Kogan (2016): Why Venezuela should default, in: *The New York Times* (21.12. 2016).

various negotiation forums for the various asset classes: Paris Club, London Club, ad-hoc forums for bondholders, no multilateral relief (officially) outside HIPC/MDRI, no forum for official creditors outside the Paris Club (but a rather superstitious comparative treatment clause in Club agreements), and more or less independent domestic legal systems for the treatment of domestic debt.

In the past, this multitude of forums has regularly led to different creditor groups denying or postponing debt relief, in order to await concessions by competing creditors. As a result, the relief finally accomplished was normally less ambitious for the debtor and more expensive for the creditor than the same relief effect would have cost through a timely and coherent negotiation process.

As debt sustainability cannot be defined with regard to individual claims but only with regard to the entirety of a country's debt stock, debt restructuring for the entire debt stock in one single process is the first of several requirements for a more efficient process in the future. It will thus also be one such element in our proposal for a regional/thematic debt relief initiative outlined below.

4. The Global/National Dilemma in the Design of a New Debt Relief Regime and the Case for a Third Approach between the Two

Reform initiatives for the global debt restructuring regime have regularly focussed on global mechanisms, such as the early proposals for a Sovereign Insolvency Framework by UNCTAD,[16] Kunibert Raffer, Latin American economists Alberto Acosta and Oscar Ugarteche,[17] and the IMF.[18] Given that the weaknesses of existing regimes and upcoming new crises are indeed global phenomena, aiming at establishing a global mechanism is appropriate. However, this chapter shows that there is still another equally relevant approach.

16. UNCTAD's Trade and Development Report 1986 provided the first broad outline of a sovereign debt workout mechanism based on rule of law. As it was not yet a detailed implementable proposal, it is only referenced here and not under the proposals below.

17. A. Acosta / O. Ugarteche (2003): A favor de un tribunal internacional de arbitraje de deuda soberana (TIADS). *Nueva Sociedad:* 183.

18. A. Krueger (2002): *A New Approach to Sovereign Debt Restructuring*. Washington, DC: International Monetary Fund.

a. A Global Approach: Proposals and Political Deadlocks

Among the most important proposals for a fair and transparent global debt workout mechanism, we find:

- The proposal to internationalize Chapter 9 of the US Insolvency code, which organizes the insolvency of »municipalities« — i. e. public bodies with governing powers — elaborated by Professor Kunibert Raffer of the University of Vienna.[19] This proposal already overcame the counter-argument that private sector insolvency cannot be applied in the sovereign sphere, because there was no way to respect the democratic substance of public entities. Chapter 9 does exactly this in the domestic US context, by dealing with the insolvency of public entities with governing powers. Adding arbitration as an instrument for decision-making would allow Chapter 9 to be applied in an international setting.

- The IMF's attempt to establish a Sovereign Debt Restructuring Mechanism (SDRM)[20] between 2001 and 2003. That proposal went a long way in establishing a comprehensive process with the IMF's power as a guarantee that no creditor would escape a multilateral agreement. This was built on the Fund's almost universal membership, forcing dissenting creditors or non-complying jurisdiction to either change their practice in line with the SDRM or leave the IMF. However, by installing itself more or less directly as the arbiter in the process, the IMF provided opponents with the arguments to ultimately reject the proposal: it failed to gain sufficient traction with international creditors and IMF member governments, who feared that the SDRM would constitute too much of an intervention into markets, which at that time were just recovering from the Asian crisis. However, resistance came also from debtors in the global south and international civil society who were not prepared to accept an institution as arbiter, which at that time had a questionable record even as a provider of technical expertise, because of its strong bias towards creditors' interests.

19. https://homepage.univie.ac.at/kunibert.raffer/.

20. http://www.imf.org/en/news/articles/2015/09/28/04/54/vc021802.

- The proposal of a Fair and Transparent Arbitration Process (FTAP),[21] developed by the global Jubilee movement. It largely builds on Raffer's works, but includes more options for decision-making beyond Raffer's arbitration proposal, such as mediation and conciliation. This aims at a higher degree of flexibility in accommodating different situations, as in some circumstances viable compromises between debtors and creditors might be reached through a less formal mediation or facilitation process. There were several variants of the FTAP, such as AFRODAD's Fair and Transparent Arbitration (FTA)[22] and its Latin American version *Tribunal de Arbitraje sobre Deuda Soberana* (TIADS)[23] developed by Latin American Economists Alberto Acosta and Oscar Ugarteche. TIADS aims at establishing a decision-making body on sovereign debt at the UN or at the International Chamber of Commerce. In the political arena, such proposals have been taken up occasionally by parliamentarian bodies, such as the Latin American Parliament in its »Montevideo Declaration«, but have not attracted political clout to the extent of the SDRM.

- Building among others on proposals for a Sovereign Debt Forum at the Canadian Think Tank CIGI, Professors Jo Stiglitz and Martin Guzman have introduced a soft law approach to sovereign debt restructuring, based on principles approved by the UN General Assembly in 2015.[24] This »family« of proposals, like the one outlined below, aims at making procedural innovation as easily manageable as possible, in order to enable meaningful relief, before the rising debt levels lead to the repetition of the 1980s debt crisis.

- The Dutch government developed a proposal for a sovereign debt tribunal, established at the International Court of Arbitration in The Hague.[25] Unfortunately this proposal, which was well received in the global law community, was abandoned when national elections replaced the proactive Labour Party government with a more reluctant centre-right administration.

None of these proposals has thus far met with sufficient political backing to build a global consensus strong enough to actually establish it through an international treaty, or to reform common international practice informally. There would indeed be some leeway for an informal implementation by the most important participants in global capital markets. It should be noted that the Paris Club, which has been functioning since 1956, has also never been more than an informal arrangement.

b. The National Approach: Moving Forward from a Weak Position

As we have seen before, not all sovereign debts are potentially subject to a standardized procedure, when it comes to a renegotiation. Bond exchanges are regularly negotiated ad hoc. A sort of standard procedure does exist informally, building on the formation of one or several creditor committees who then serve as the sovereign's counterpart(s). These negotiations are by definition piecemeal — i. e. they deal with one particular asset class, sometimes just a single instrument. That does not mean that no meaningful debt restructuring can be accomplished through such piecemeal and ad hoc procedures. However, it is necessarily confined to striking a compromise between the particular asset class and the debtor, normally based on the balance of power between the two parties. Whether the sovereign debt becomes sustainable — either directly or by other creditors striking similar deals — is beyond the reach of those who sit to negotiate. Thus, this procedure stands in a stark contrast to the fact that debt sustainability can never be defined — and seldom accomplished — by dealing with just a part of the debtor's external obligations.

Outside the realm of bond restructurings, some creditors have in the past attempted to negotiate individual arrangements with several or even the entirety of their creditors, without any reference to standardized procedures or the use of existing forums. Such »stand-alone«

21. J. Kaiser (2013): Resolving Sovereign Debt Crises. FES Dialogue on Globalization. Berlin: Friedrich-Ebert-Stiftung; available at: http://library.fes.de/pdf-files/iez/10263.pdf.

22. AFRODAD (2002): Call for the Establishment of a Fair and Transparent Arbitration Mechanism on Debt.

23. http://globalizacion.org/wp-content/uploads/2016/01/DocDisc1TiadsUgartecheAcosta2003.pdf.

24. M. Guzman and J. Stiglitz (2016): A Soft Law Approach to Sovereign Debt Restructuring. FES International Policy Analysis. Berlin: Friedrich-Ebert-Stiftung; available at: http://library.fes.de/pdf-files/iez/12873.pdf.

25. Arbitration and Sovereign Debt (2012), a paper prepared by the Steering Committee of the Netherlands Government and the Permanent Court of Arbitration.

negotiations have provided spectacular successes, including the 1953 London Agreement on German External Debt[26] and the 1970 agreement on Indonesia's debt from the Sukarno era.[27] However, in principle and different from these two impressive success stories, a debtor who negotiates all on its own is typically in a weak position, which is why most (poor country) debtors accept the forums and standard procedures established by their creditors. The most spectacular example for such a failed national strategy has been Peruvian president Alan Garcia's declaration to limit annual debt service to a maximum of 10 per cent of export earning in 1985. While indeed debt service brought down from the high levels of 44 per cent in 1980 to around 10 per cent through simply defaulting on a part of the payment obligations, Peru was quickly isolated from most capital inflows and depleted its reserves in order to keep essential services financed. Between 1991 and 1993, debt service rations were already back at the height of the early 1980s,[28] and hyperinflation resulted in a severe economic and political crisis in Peru.

Still, however, leaving debt renegotiations to the debtor's ad hoc initiatives when we see global processes are causing debt problems to arise in similar ways through broader groups of countries — for instance, regions or countries that share a specific risk, such as climate change or commodity price slumps — will hardly lead to the efficient and speedy processes needed in order to minimize the negative fallouts from debt crises on a global scale.

This is why in the following chapters we suggest a third approach between the individual country approach and the ambitions for a global statutory framework, which under present political circumstances is not very likely to be achieved before more countries are forced into default. First we will take a brief look back at an important piece of modern debt history, which shows that this type of approach is anything but novel.

26. J. Kaiser (2013): *One made it our of the debt trap. Lessons from the London Debt Agreement of 1953 for Current Debt Crises.* FES Dialogue on Globalization. Berlin: Friedrich-Ebert-Stiftung.

27. A. Hoffert (2001): The Indonesian Debt Accord. Fakultät für Wirtschaftswissenschafter der Ruhr Universität Bochum. Discussion Paper No. 05-01.

28. For a detailed description of the Alan Garcia experience see: P. Robinson (n.d.): The Failed Heterodox Experiment in Peru: Alan García 1985–1990; available at: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.200.9348&rep=rep1&type=pdf (last accessed on 10.4.2017).

5. Learning from the Process that Led to HIPC: Limited Target Group, Limited Relief and a Sort of Comprehensiveness

In 1995 a many low- and middle-income countries were suffering from severe and growing payment problems. While the Brady Plan had helped some of the larger debtor countries to reduce their external debt services from extreme levels,[29] smaller countries with a stronger exposure to official rather than private creditors could not benefit from this approach. Instead, they found themselves locked into the Paris Club's notoriously insufficient debt relief options. Additionally, multilateral creditors were holding an ever-growing share of the external claims on these countries, because it was them who — at the behest of their influential member governments—kept refinancing the often unsustainable debt service to bilateral official and private creditors. Multilateral claims, however, were considered to be sacrosanct at the time. The argument was that precisely because the multilateral resources served to keep debtor countries afloat, they could never be written down, because that would deprive the same debtor countries of their lender of last resort — i. e. the one and only lifeline left to them after private creditors had withdrawn and official bilateral creditors had become more and more reluctant to provide new credit lines for essential imports. This established what was called the preferential creditor status of the multilateral creditors. In reality, the status was not »preferred« in the sense of a generally better treatment of multilateral creditor as compared to bilateral creditors; it was in fact »exempt«, because it was claimed that they should forever stay out of any debt restructuring operation regardless of the severity of the debtor's problems and their own share in the entire external debt stock.[30]

In 1995 and on the initiative of two European members of the Paris Club and the World Bank — namely Sweden and Switzerland — insightful staff of the World Bank managed to organize an open and frank roundtable

29. Brazil paid 63 per cent of its annual export earnings as debt service in 1980, which was then brought down to 20 to 30 per cent by several operations under the Brady Plan.

30. For a discussion on the validity of the »preferred creditor status« of multilateral financial institutions, see: K. Raffer (2009): Preferred or Not Preferred. Thoughts on Priority Structures of Creditors. Paper prepared for discussions at the 2nd Meeting of the ILA SOVEREIGN INSOLVENCY STUDY GROUP, 16 October 2009.

meeting about this conflict between ideology and reality, which ultimately laid the foundations of what subsequently became the Heavily Indebted Poor Countries (HIPC) initiative.[31]

Essential for escaping the deadlock was the definition of a limited group of possible beneficiaries, while the rest of the world was entirely locked out of the present initiative.

Out of the three concerns against sovereign debt relief on the creditor side, which we described above, the first one (»This time is different«) had already become obsolete by the explosive rise of debt indicators in a broader group of countries, combined with actual default in quite a few of them. The second and third concerns (»Costs« and »Coordination Problems«) were then addressed through the design of the initiative. The key elements of this HIPC initiative were:

- the qualification of countries for debt relief based on their debt levels, plus a sufficiently low per capita income, plus a few less transparent criteria enforced by influential creditors;
- a fixed, but later adapted, timeline of economic reform and debt relief implementation;
- predefined benchmarks of debt sustainability indicators as targets for debt relief;
- the principled participation of all creditors in the relief effort.

By early 2017, 39 countries had qualified for the HIPC initiative, of which 36 have gone through the whole debt relief process, including its extension by the Multilateral Debt Relief Initiative (MDRI).[32] Three qualified countries — Sudan, Eritrea, and Somalia — still have not reached their decision points, primarily due to the lack of functioning statehood or willingness to co-operate with the international community. One additional country (Zimbabwe) has been »grandfathered« and may become the latecomer to the initiative, once political circumstances allow.

31. A concise description of the HIPC and MDRI initiatives can be found on the World Bank website: http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,,contentMDK:20260411~menuPK:64166739~pagePK:64166689~piPK:64166646~theSitePK:469043,00.html.

32. For a background on the Multilateral Debt Relief Initiative see: https://www.imf.org/external/np/exr/facts/mdri.htm.

The initiative's strengths were:

- HIPC could build on a broad consensus among creditors, debtors, and international financial institutions, that »something had to be done« for a certain group of countries;
- HIPC credibly addressed creditors' fears of a too broad-based and thus too costly debt relief scheme and so mustered broad participation (though this was not complete, see below);
- equal treatment of comparable cases was not perfectly, but broadly achieved.

HIPC and MDRI were successful in eliminating in large part the debt overhang of the qualified countries. The 36 countries that have gone through the process have seen a total of 74.8 billion US dollars of external debt eliminated through HIPC and an additional 41.6 billion US dollars through the MDRI.[33] Not all of this translated into fiscal space for the beneficiary countries, because much of it was just accumulated arrears and compound interest obligations of insolvent countries, which would never be paid under any circumstances.[34] Despite some differences between the material effect of the initiative and its somewhat triumphant marketing by the international financial institutions, it is uncontroversial that HIPC/MDRI relief provided a broader group of countries with the opportunity for a fresh start.

However, the initiatives also had some weaknesses, which a future debt relief scheme must try to avoid:

- HIPC had to be reformed and extended a few times — HIPC-I in 1996, HIPC-II also called the »Cologne Debt Initiative« in 1999, topping-up beyond HIPC-II in 2002, and finally through the MDRI in 2005 — because the benchmarks in the original 1996 initiative were unrealistic, and procedures were not flexible enough in the face of outright insolvencies in some countries. Thus, to some extent the initiative repeated the mistakes of the various pre-HIPC Paris Club terms of providing too little relief too late.

33. Both are given in end-2014 NPV-terms. IDA/IMF (2016): *Heavily Indebted Poor Countries (Hipc) Initiative And Multilateral Debt Relief Initiative (MDRI) — Statistical Update.* Washington, DC: International Monetary Fund; available at: http://www.imf.org/external/np/pp/eng/2016/031516.pdf (last accessed on 27.4.2017).

34. Kunibert Raffer coined the term »phantom debt« for such claims.

- Buy-in to the initiative was limited to those creditor groups that were not very important in terms of the quantity of their claims, but relevant with regard to the principle of equal treatment; this relates notably to private creditors, those that were not member of the Paris Club members, as well as some of the small regional multilateral financial institutions.[35]

- Its access criteria were not always coherently applied.[36]

- HIPC/MDRI was a one-off debt relief effort, which aimed at solving an existing debt crisis, implicitly assuming that beneficiary countries would not enter into any new crisis thereafter.

6. Beyond HIPC: Where a New Regional Approach Needs to Be Different

Considering the weaknesses of the HIPC initiative, there are a few key elements, where a future debt relief initiative of any kind — not only those elaborated below — should be different:

- It should feature standing mechanisms that can be applied whenever debt crises occur, rather than a one-off debt reduction operation that simply addresses a presently existing crisis.

- It should work on the basis of a comprehensive negotiation framework — i. e. all claims on the debtor have to be brought into the process and a restructuring has to be defined, which is sufficient to restore debt sustainability and hence the fiscal and macro-economic viability of the debtor in question.

- Decision-making processes should function according to fundamental principles of the rule of law — i. e. through impartial decision-making or at least some element of impartiality in the process, which would be strong enough to balance the normal creditor overweight.

- Decisions should be based on an equally impartial assessment of the debtor's need for relief.

What then are the elements we should preserve from the HIPC process and emulate in the changed circumstances?

- A debt relief initiative can be targeted to a limited group of countries, which are under a common threat to their debt sustainability, without pre-empting the treatment of other countries outside the scheme.

- A debt relief initiative can be agreed upon by the most important creditors with the affected debtors, without needing a formal global consensus on principles or technicalities; various creditors can join the restructuring process at different stages of the process.

- A debt relief scheme need not be immediately implemented in all potential beneficiary debtor countries, but should exist as an option for the debtor.[37]

Based on these guidelines, a regional/thematic initiative would consist of the following elements:

- An agreement between the debtor countries in question, the most relevant multilateral financial institutions, and most important creditors to establish a debt relief option.

- A standard roadmap for the negotiation process from the debtor country's application to the ultimate decision or recommendation by an independent body.

35. According to the end-2016 Status of Implementation Report there are still some 2.4 billion US dollars outstanding to official creditors who do not belong to the Paris Club and another 165 million US dollars to small multilateral creditors. The HIPC report has ceased more accurately identifying the amounts still outstanding to private creditors, however, it has revealed that some 600 million US dollars are known to be presently under litigation. See: IDA/IMF (2016), note 34.

36. For instance, Nigeria was on the original list, but was removed when the country overcame the Sani Abacha dictatorship and adopted a parliamentary democracy under President Obasanjo. The formal pretext was that Nigeria was not an IDA-only country, but that was already the case when it was included into the first HIPC list in 1996. In fact, the real reason was that after its (still weak) democratization, the implementation of the HIPC initiative could no longer be denied by pointing to the notorious corruption and bad governance of Nigeria's political system — at least not in comparison to other smaller HIPCs, whose inclusion in the initiative was uncontroversial. With an external debt of more than 30 billion US dollars, the country was the heavyweight among HIPC countries, and a HIPC-style cancellation was considered too costly for its official creditors. In 2005, it received less ambitious relief from the Paris Club.

37. In the HIPC case, there have been countries that have been taken off the list by the international financial institutions (e. g.. Nigeria, see above), as well as countries that have decided not to use the option of HIPC relief. In fact, all Asian countries that had preliminarily qualified for the initiative — with the exception of Afghanistan — have decided against participating. While this certainly implies an inroad for eventual external pressure or suasion from stakeholders, the principle of a sovereign decision rather than an automatic inclusion is preferable.

- An agreement about target parameters for group-specific debt sustainability. In general, the individually or group-wise most critical debt sustainability indicator should be applied in order to calibrate debt relief.

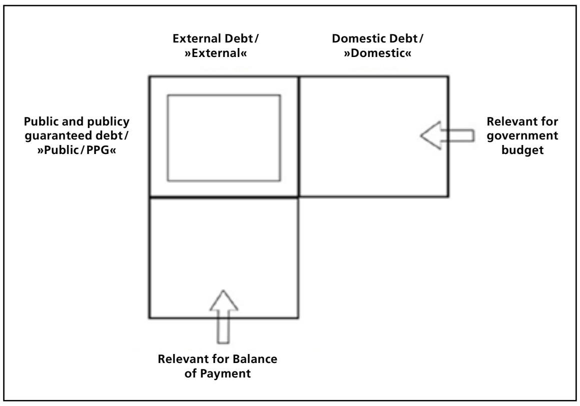
7. Below the Level of a Global Statutory Insolvency Regime: A Debt Relief Option for Regionally or Thematically[38] Defined Country Groups

In order to illustrate, how such an »HIPC emulation« could work and what its financial implications in the present global debt context would be, we present two exemplary groups of debtor countries following the logics of a regionally defined and thematically defined group. The detailed presentations of both groups in the tables below show the group member countries, which have qualified by at least one of the five most common and most relevant indicators of debt distress breaching a critical threshold. Data refer to end-2015 and are taken from the World Bank's International Debt Statistics database[39] and the IMF.[40]

Different from the times of the HIPC initiative, when almost all external debt of the included countries was public or publicly guaranteed, currently in most countries a substantial share of the public debt is domestic and a part of the external debt is owed by private creditors. This makes calculations of an eventually implementable debt relief more complicated.

The following graph demonstrates the multidimensional character of present debt consideration — while during the implementation of the HIPC initiative, the public external debt in the upper left segment was the only relevant debt category.

The present exercise is an illustration of what the dimensions of debt relief under the suggested regional/thematic initiative could be. Therefore, we have chosen



the following methodology, which in its implementation should of course be subject to a tailor-made individual debt sustainability analysis:

We define the need for debt relief to be the difference between the highest of the five debt indicators, which erlassjahr.de has applied in its Sovereign Debt Monitor, and the lowest of the three sustainability thresholds for that particular indicator.

The debt indicators and thresholds and their respective thresholds are:

- Public debt / GDP (49 per cent);
- Public debt / Public revenue (200 per cent);
- External debt /GDP (40 per cent);
- External debt / Export earnings (150 per cent);
- External debt service (principal and interest) / Export earnings (15 per cent).

What it takes in term of debt relief in order to bring the indicator down to that level is called the overall reduction factor. In defining the need for debt relief in this »generous« manner, we deliberately follow the logic, that if you decide to go for debt relief at all, it would be better do it in a way that provides a high degree of probability that the beneficiary will not have to come back for additional debt relief in the nearer future — even if this implies that such a »secure« debt level could already have been reached with a few centimetres less of a haircut.

Depending on whether the total public debt or the total external debt underlies the most critical indicator, we then apply the common reduction factor to either of the two debt stocks. We do not make any specific recommendation regarding the distribution of the necessary

38. The term »thematically« here refers to a group of countries that may be regionally disperse, but share a common characteristic, which is relevant for a present threat of over-indebtedness and has substantial implications for the future economic development.

39. http://data.worldbank.org/data-catalog/international-debt-statistics.

40. Only in the case of Barbados we had to resort to an older database (the CIA World Factbook) with a figure for 2011, which only constitutes a proxy for today's total external debt. The IMF has refrained from providing any data on total external debt in its latest Art. IV report.

debt relief between public and private external debt or domestic and external debt. As a general rule, reductions should resemble HIPC relief as much as possible, which has focussed entirely on public and publicly guaranteed external debt. Given the more complex creditor profiles and the specific sustainability risks — which may stem from domestic public debt and private external debt, respectively — neither of two categories is pre-emptively ruled out of the debt relief effort:

- Private external debt carries a high risk of becoming a contingent liability of the state, ultimately requiring debt relief beyond what would be necessary, if only the public external debt were to be considered.

- Public domestic debt can suffocate public finances as much as external debt can, particularly because it regularly comes with much higher interest rates.

The potential risks, which these two categories of debt imply, require that they are a part of both debt sustainability considerations and overall relief efforts. It does not mean, however, that they are technically treated in the same way as public external debt.

It is important to note that we are talking about a debt relief *option* here, which qualified countries may wish to use or not. This is different from HIPC, where — while dropouts also occurred — it was clear that most qualified countries would indeed make use of the solution, which they were finally offered for an undeniable problem. In order to assess the extent to which there would most likely be an immediate request for relief in each of the two groups, we have defined a »priority« subgroup. »Priority« includes the countries we consider to be at the highest and most immediate risk of default. As a proxy, we have defined this to be the case if either:

- the country is assigned a »high« risk of debt distress in its IMF debt sustainability analysis for low-income and PRGT-eligible countries;

- or it finds itself in the »I. quadrant« of erlassjahr.de's risk assessment matrix.[41] This quadrant includes those countries, which have the highest debt indicators *and* an overall or even exclusively negative development of its five debt indicators in the period from 2011 to 2015.

41. erlassjahr.de / Misereor (2017): *Schuldenreport 2017* (Düsseldorf: elassjahr.de),13; see Annex.

As there are four countries in the Climate Change Effects Group, which have qualified as being most affected by climate change (see below) and find themselves included in erlassjahr.de's Sovereign Debt Monitor because they are considered to be at »moderate« risk of distress by the IMF, we have four »no relief« cases in this group. They have not been left out, because for an illustration like this, it seems appropriate to provide a coherent picture of all those who could potentially qualify. Sovereign debt risks can build up very quickly.

a. The Logic of Sub-groups for Debt Relief

The identification of country groups for which a debt relief option shall be defined builds on two parameters:

- There is a group-specific characteristic — i.e. the affiliation to a specific region or a specific threat to fiscal or external debt sustainability;

- There is a debt problem defined by at least one out of five debt indicators being in at least the lowest critical range as defined in erlassjahr.de's Global Sovereign Debt Monitor.[42] This latter condition serves to avoid an artificial and useless inflation of country groups by members, who would neither need nor wish to consider debt relief.

i. Regional Groups: The Caribbean as an Example

For more than a decade, the Caribbean has been a hotbed of sovereign over-indebtedness without finding much attention. A few partial debt relief agreements have been reached for some countries in different ways, including Jamaica, St. Kitts and Nevis, and Grenada.

For illustrative purposes, we have designed the Caribbean Group to include seven small island developing states in the Eastern Caribbean: Antigua and Barbuda, Barbados, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines.

42. erlassjahr.de / Misereor (2017): *Schuldenreport 2017*.

The basis for this group selection:

- Caribbean countries have almost without exception suffered from a combination of high economic vulnerability due to changes in economic policies in other parts of the world, particularly the change in the EU banana market access policy.

- The whole region is among the most vulnerable to natural disasters, particularly hurricanes, which cause in any country in the group on average damages of 8.7 per cent of GNI in a »no climate change« scenario and are expected to suffer staggering annual losses of 10.1 per cent in the »high climate change« scenario.[43] However, variations in loss probability are very large, with Antigua and Barbuda (8.2 per cent / 12.9 per cent) in the high range, Dominica (16.0 per cent / 22.8 per cent) in the extreme range, and St. Vincent and the Grenadines and Barbados clearly below average.

- Efforts to establish market-based hurricane insurance schemes for the region have proven to be unfeasible.[44] Given the narrow basis for contributions and the extraordinary level of damage, if indeed a hurricane strikes, no marketable balance could be established. Therefore allowing for debt relief in strictly defined situations of natural disasters would be the most effective way of immediately mobilizing aid and reconstruction resources — namely by simply leaving the funds in the affected country, where they already are.

The region is characterized by the exceptional smallness of individual states, which makes debt relief relatively »cheap«. Procedural innovation as suggested in our proposal would thus be almost cost-free to creditors.

43. S. Acevedo (2016): Gone with the Wind: Estimating Hurricane Climate Change Costs in the Caribbean. IMF Working Paper WP/16/199: 24.

44. »The United Nations and the IMF have proposed the creation of Caribbean Resilience and Stabilization Funds, but no such funds currently exist except the Caribbean Catastrophe Risk Insurance Facility (CCRIF). The CCRIF was launched with sponsorship from the World Bank and covers only major hurricanes or earthquakes, with a relatively small payout. The facility generally does not cover flood damages«. Moody's Investor Services (2016): *Caribbean Sovereigns: The Silent Debt Crisis*. For a more recent overview of options see IMF (2016): Small States: Resilience to Natural Disasters and Climate Change — Role for the IMF. Policy Paper. Washington, DC: International Monetary Fund.

ii. A Thematic Group: Debt Vulnerabilities in Countries Affected by Climate Change

Several economic and political macro-trends and risks could be meaningfully taken as a basis for providing countries with a debt relief option. In line with more recent discussions among policymakers, charity NGOs, and/or peace initiatives, among others, such a group could refer to:

- crisis countries in Africa, based on the present G20 presidency's special focus on that continent;
- countries affected by the present refugee crisis, triggered by armed conflicts in North Africa and the Middle East;
- countries particularly suffering from the effects of climate change;
- countries that have suffered most from the slump in commodity prices post-2015.

We have chosen the Climate Change Effects Group for our illustration, because both the slump in commodity prices and the dramatic effects of warfare in the Middle East are more transitional phenomena, which may already have undergone changes for the better or the worse, when a debt relief scheme has been built from scratch along the lines described in the following chapters. The lasting and long-term consequences of climate change, on the other hand, are certain to remain, regardless of how long it takes the international community to develop an implementable debt relief scheme. Of course, thematic groups are more difficult to coherently define than regional groups, and an element of arbitrariness in identifying the »ins« and »outs« can be avoided no more than it was during the design of the HIPC initiative.

Regarding the Climate Change Effects Group, we include countries with a score of 40 or less on the ND-GAIN ranking of the University of Notre Dame,[45] which have at least one of the five common debt sustainability indicators in a critical range. The 24 members of this group are[46] Afghanistan, Angola, Burkina Faso, Burundi, Chad,

45. http://index.gain.org/ranking.

46. Eritrea and Sudan have been taken out because they may still receive debt reduction under the existing HIPC/MDRI initiatives. Zimbabwe has been grandfathered for the initiative, and has therefore been taken out, too. Afghanistan (disproportional shadow economy) and Yemen (lack of functioning statehood) have been kept on the list, although relief operations would probably not be feasible in the near future.

Central African Republic, Congo DR, Djibouti, Gambia, Guinea, Guinea-Bissau, Haiti, Kenya, Madagascar, Malawi, Mauritania, Mozambique, Mali, Niger, Papua New Guinea, Sierra Leone, Solomon Islands, Togo, Yemen.

Both groups' calculations are to be found in the annex.

b. How it Would Work

In both cases — the regional as well as the thematic group — the initiative's establishment would not imply any immediate debt relief. Rather, it would lay out the mechanisms that will lead to debt relief, once the beneficiary country requests it under the due procedure. The process would thus look as follows:[47]

- The regional or thematic initiative would have to be established by international consensus (see next paragraph).
- A country that has been identified as a potential beneficiary requests debt relief under the scheme.
- The need for debt relief needs to be verified under either of two options:
  - the membership in the beneficiary group as such implies automatic qualification, once the government requests it, or;
  - an independent body affirms that the conditions for immediate debt relief are met. This again can happen through either of two options:
    - a technically competent body affirms that a predefined threshold — e.g. for hurricane damages — has been breached, which would then automatically trigger the debt relief process; its calibration, however, would still have to be the result of a due debt sustainability analysis, as under the first option;[48]
    - a comprehensive assessment of the debtor's debt situation leads to the conclusion that debt relief is needed; this option would not imply any automatism; the assessment needs to be an open process.
- Linked to the assessment, *whether* debt relief is necessary is then the definition of the *amount* of debt relief. This again needs to be done by an institution that is entirely independent of the debtor/beneficiary and any of its creditors. This can be the »Debt Workout Institution« described in Chapter 9, or any other body, agreed upon by the parties. Particularly in the case of a regionally defined initiative, it may also be a regional institution provided that extra-regional parties trust its impartiality and independence.

c. Debt Relief under the Regional and Thematic Schemes and their Financial Implications

As we can see from the calculations in the annex, the most extreme debt relief facilitated by the scheme would be a nominal 3.7 billion US dollars in the case of the Caribbean Group and 66.6 billion US dollars in the case of the Climate Change Effects Group.

In the former, the effort would be most concentrated in the case of Barbados, while out of the total of eight countries, three more would qualify (Antigua and Barbuda, Barbados, and Dominica), and on the basis of their external debt indicators and another three on the basis of their public debt indicators, namely St. Kitts & Nevis, St. Lucia and St. Vincent & the Grenadines. Grenada is not considered for relief under the proposed scheme, because it has just obtained a restructuring from its bilateral official and commercial creditors, the results of which are not yet captured by the end-2015 data. While Grenada is still considered to be »in debt distress« by the IMF, it is still too early to assess whether that relief has been sufficient to restart the economy as hoped for by the parties.

Four countries to be included in the initiative would also be »priority« countries (highlighted in the table), which could be expected to be interested in participating in the initiative. However, Barbados is combining the weakest database with a relative overweight of its external debt over the other three. Moreover, it shows a relatively low exposure to the greatest risks to economic sustainabil-

47. The following is a shortened version of the more sophisticated »Sovereign Debt Workout Roadmap« presented by UNCTAD in 2015. See: UNCTAD (2015): Roadmap and Guide to Sovereign Debt Restructuring. New York: United Nations; available at: http://unctad.org/en/PublicationsLibrary/gdsddf2015misc1_en.pdf (last accessed on 1.3.2017). The guide would be the first reference for any further elaboration of the processes details, which can only be broadly covered here.

48. Such an assessment could also have important legal implications, because damages through *force majeure* events — such as hurricanes — are among the few factors that could trigger the *rebus sic stantibus* clause in loan contracts. See: M. Goldmann (2016): Putting Your Faith in Good Faith: A Principled Strategy for Smoother Sovereign debt Workouts, in: *The Yale Journal of International Law Online* Vol. 41 (2): 134; available at: https://campuspress.yale.edu/yjil/files/2016/10/H-Goldmann-Special-Edition-1zxbg5i.pdf (last accessed on 21.3.2017).

ity — namely hurricanes. Therefor it may make sense to identify a »super-priority« group in the Caribbean Group, which would then include Antigua and Barbuda as well as Dominica, as the two nations that combine the highest risk exposure with critical debt indicators. As a result, the overall costs for this »pilot« initiative would be minimal — just 172 million US dollars.

The Climate Change Effects Group is bigger and more complex than the Caribbean Group. Consequently, the potential costs would not be quite as negligible as in the Caribbean: about 66.6 billion US dollars as a maximum for the whole group and 16.6 billion US dollars for the »priority« group.

Priority countries that are either at high risk of debt distress according to the IMF or have the highest indicators combined with the most negative trend according to erlassjahr.de are Afghanistan, Burundi, Central African Republic, Chad, Djibouti, The Gambia, Mauritania, and Yemen.

In the priority subgroup, there is again one heavyweight (Yemen), which, moreover is a country with the highest degree of political instability, from where public external debt service is presently not outflowing regularly, and where a sophisticated and complex debt relief agreement would as much require a political stabilization as in the three outstanding HIPC cases, i. e. Sudan, Eritrea and Somalia. If we take Yemen out of this group, a »pioneer« debt relief to combat climate change initiative would cost in the range of 3 billion US dollars. In that group, Mauritania is the one case where the proposed scheme could help to finally provide debt relief for a country, whose critical state debt situation has long since been acknowledged by everyone from the IMF to Jubilee.

8. How It Could Be Brought About

A proposal like the present one implies political, technical, and legal innovation. It aims at addressing a problem with unpredictable dimensions over the medium term. Therefore conceptual and political flexibility is necessary. Still, a few steps for the way to political implementation can be identified:

- A regional/thematic debt relief initiative requires a consensus amongst the most relevant debtor and creditor groups. Indebted sovereigns, a critical mass of creditors, and a few relevant intergovernmental financial institutions (IFIs) need to agree that something has to be done. This can be brought about, for instance, through a closed consultation like the one in 1995, which opened the door to a consensus for what later became the HIPC initiative.

- There has to be an agreement about applicable criteria, group memberships, and standardized negotiation processes among the three parties involved — debtors, creditors, and IFIs. This goes beyond the imminent consensus building process described above, because it implies agreement about technicalities, which have a huge influence on the dimensions, the validity, and ultimately the effectiveness of an initiative.

- Provisions have to be made in order to make a joint relief effort legally watertight. This may relate to national budget laws — as for instance in Germany, where any debt relief at the expense of the state budget is ruled out, unless it comes as participation in a multilateral agreement. Here it would just be necessary to clarify that such an initiative be qualified as a »multilateral agreement«. It may, however, also relate to the prevention of vulture funds freeloading on official sector relief. This may imply more comprehensive legislation, such as anti-vulture laws like those in place in Belgium and the UK.[49]

- There has to be at least a minimal infrastructure in place to technically implement the initiative. This can — as in the case of HIPC/MDRI — be an existing international financial institution. However, as outlined above with regard to the necessary neutrality of any body that plays a key role in a debt restructuring process, there would be merit in designing a specific small and flexible infrastructure for catalysing this process. One such option is presented in the next chapter.

- The negotiation process itself can then follow the stepwise approach outlined in the »UNCTAD Roadm-

49. Belgische Kamer van Volksvertegenwoordigers (2015): Wetvorstelle teneinde de activiteiten van de aasgierfondsen aan te packen; 19.Juli 2015. For a broader overview see: A. Iversen (2015): Holdout Creditor Litigation. An assessment of legislative initiatives to counter aggressive creditor litigation. University of Oslo Faculty of Law Legal Studies N. 2015-13.

ap and Guide to Sovereign Debt Workouts«,[50] which in turn informed the formulation of the »UN Basic Principles on Sovereign Debt Restructuring Processes« in 2015.[51]

9. A Pragmatic First Step: Establishing a »Debt Workout Institution«

One of the reasons the HIPC initiative functioned relatively smoothly was that it had two powerful international financial institutions providing the necessary infrastructure: the World Bank and the International Monetary Fund (IMF). Unfortunately this valuable service was bought at the expense of an undue influence of these two creditors over the process outcome, including inter-creditor burden sharing. It is therefore advisable to establish an independent body, which in a catalytic way serves as infrastructure for the initiative. Given the overwhelming importance of impartiality in the decision-making process, an institution that is independent of all parties involved is essential.

This is how such an institution could be designed:

The »Institution«: Its Core Mandate

The major purpose of the institution would be to overcome the two key deficiencies in presently dealing with sovereign debt crises:

- the lack of comprehensiveness;
- the lack of impartiality in assessing the need for debt relief and in decision-making.

As a necessarily impartial body, the institution would not be an attorney or advocate of the debtor with regard to the outcome of a restructuring process. It would, however, support the debtor in the process, because the debtor is the party who initiates it. Ending a sovereign debt impasse through a predefined and balanced process is in everyone's interest. In that sense, the »institution's« role in the process would start at the very informal technical support level, and then be upscaled to more formal and binding processes, if the (preferable) informal and non-binding ones do not provide agreements that the parties abide by. Thus, the institution:

- supports sovereign debtors with regard to debt workout procedures;
- facilitates the organization of exploratory meetings with all creditors;
- supports the quest for expertise/ independent assessment with regard to debt sustainability;
- mediates a conciliatory solution between a sovereign and all its creditors upon request by the sovereign;
- organizes a debt arbitration process based on UNCITRAL principles and rules, if (and only if) mediation fails.

Institutionalization

For the institution to start functioning, there does not have to be an international treaty or other statutory underpinning, though at a later stage it may be advisable to define one. However, it should at least have an informal UN mandate, such as a resolution, which welcomes its creation and encourages sovereigns to seek its support. Even with this mandate, however, it does not have to be part of the UN system itself — although an affiliation with a UN body is an option, because UN institutions are neither debtors nor creditors themselves. It should be governed by public interest, so it would not be a private or for-profit organization, but could be organized under private law; an option is a board of »eminent persons«.

It has a very small staff, but can mobilize experts, facilitators, mediators, and arbitrators quickly, reliably, and efficiently.

It could be called »sovereign debt restructuring liaison office« or something comparable.

It does not have to be completely available at the start but can begin as an incipient institution, with rules, bylaws, and infrastructure developing over time.

Wherever the institution engages in cases of debt restructuring, there can be three levels of enforcement of the results of processes organized by the institution:

50. UNCTAD: Roadmap and Guide to Sovereign debt Workouts, see note 48.

51. UN General Assembly (2015): Basic Principles on Sovereign Debt Restructuring Processes. New York: United Nations; available at: http://unctad.org/meetings/en/SessionalDocuments/a69L84_en.pdf (last accessed on 24.2.2017).

- domestic law in all jurisdictions, particularly the ones under which debt is contracted; specific legal regulations can include the type of anti-vulture fund laws, which are in force in Britain and Belgium; the institution encourages and supports the creation of such laws;

- recognition of arbitral awards under the New York Convention on the Recognition of Foreign Arbitral Awards[52] and eventually other national laws, providing enforcement for consensually organized processes below the level of arbitration;

- de facto enforcement through the cessation of payments by the debtor based on negotiation outcomes facilitated by the institution and the impossibility for creditors to attach debtors' assets.[53]

Part of the Broader Set-up

Beyond the immediate services it can provide to indebted sovereigns, the institution can serve additional purposes in the context of global debt management:

- it can manage an inventory of best practices, rules and regulations on debt sustainability and procedures for creditor aggregation;

- it can serve as a rallying point for information exchange, extending essential debt restructuring databases, such as Cruces and Trebesch.[54]

10. The Political Way Forward

How can a targeted debt relief initiative, as outlined above, be brought about? There is no ready-made roadmap for such a process. The history of how HIPC was brought about — by a key group of dedicated World Bank staff together with supporters in other institutions and member governments as well as civil society — provides some lessons to be learnt. The following are therefore a few recommendations for those, who want to put their political weight behind a reform:

- Do it during good times, not in the middle of a debt crisis.

As outlined above in Chapter 3, the »This time is different« syndrome is a serious threat to any innovation regarding debtor-creditor relations. Creditors' intrinsic inclination to gain time and avoid unpleasant decisions stands in stark contrast to the experiences of past reform processes — namely, that they are more difficult, the more countries are already in or immediately before sovereign default. As an illustration: policymakers in Germany understood that a global sovereign debt workout mechanism would have been extremely helpful in order to resolve the Greek crisis in 2010 and 2012. However, it was impossible to discuss global mechanisms at that time, because too many relevant stakeholders — like the governments of Germany, France, and Italy — immediately based their positions not on the merits for future global debt crises, but on what it might eventually mean in financial terms for their exposure to Greece.

Hard law and soft law regulations cannot be discussed, decided upon, and approved with a view to their effects on imminent situations. This is, why they should be worked out in »quiet times«. Obviously, this intention will again meet with »no more crises ever again« attitudes. Overcoming them with a view to the fact that no debt crisis will ever be the last one is the most relevant challenge to responsible policymakers in debtor as well as creditor countries.[55]

Presently we are in a situation, where we have prominent and spectacular incidents of sovereign debt crises — such as Greece and Mozambique — but no across-the-board default series in many countries. Therefore, the moment for an initiative is still given. However, this window of political opportunity may close quickly, as global interest rates rise and particularly poorer countries may find

52. http://www.newyorkconvention.org.

53. While the 2014/5 rulings of US courts in the case of NML Capital vs. Argentina have demonstrated that there can indeed be ways and means for litigating creditors to seize sovereign assets, it still holds that the legal way is a questionable option for the vast majority of creditors, and bona fide creditors generally have an incentive to prefer a negotiated outcome over the questionable merits of litigation, as long as they feel that a process has been fair and impartial — which is what the present proposal has tried to outline.

54. J. Cruces / C. Trebesch (2011): Sovereign defaults: The price of haircuts. Paris School of Economics; available at: http://www.parisschoolofeconomics.eu/IMG/pdf/Cruces-Trebesch-oct2011.pdf (last accessed on 2.2.2017).

55. This point has been made clear, for example by then Prime Minister of Antigua and Barbuda before the UN General Assembly in 2011, when he referred to the »seemingly unending crisis« and called for the creation of a sovereign debt workout mechanism. See: H.E. Mr Baldwin Spencer, Prime Minister: Statement before the UN General Assembly 24 September 2011.

themselves with severe refinancing problems, which can lead to a broader group of countries defaulting.

- Build political consensus.

Bringing HIPC about took an extremely long time — even while debt indicators in some of the countries, which later benefitted from HIPC, had already reached absurd levels. One of the reasons for the delay was that the crisis primarily affected low-income countries, which were not at the centre of global attention. Thus in public perception, they were not related to a global economic, social, or environmental crisis. This is different with regard to the next global debt crisis, which is currently emerging:

- There is a far broader group of countries affected, including some systemic middle-income countries — such as Colombia, Ukraine, and even Brazil, which in the 1990s had been dealt with under the Brady Plan, not to mention the on-going Eurozone crisis with its focus on Greece.

- The fiscal and external debt unsustainability is much more intrinsically related to political and social crises, which receive a high degree of public attention, particularly the climate and the refugee crises.

These alarming threats to global stability do imply a chance for a broader consensus, particularly when it targets a well-focussed problem, such as debt unsustainability in refugees' countries of origin. Still this consensus needs to materialize in the form of political will and initiatives. The above proposal for the relatively insignificant Caribbean Group and the slightly more heavyweight Climate Change Effects Group, could »test« the innovative procedures that — in the cases of successful debt restructuring processes — could inform the establishment of a more ambitious mechanism.

- Build on existing global reform efforts.

There is no need to reinvent the wheel. Discussions about a fairer and more efficient sovereign debt workout mechanism are among the most »mature« topics regarding the global financial architecture. Most importantly, the UN system has produced guides, roadmaps, country and regional analyses, which can be built on.

Furthermore, beyond the substantial level, the institutional clout of those who have worked on proposals from FTAP to SDRM can be brought on board. One of the most disappointing experiences during the 2014/2015 UN General Assembly for a sovereign debt workout reform was the IMF's blunt rejection to follow the UN General Assembly's invitation to participate in the consultative process. Bringing multi-stakeholder perspectives into conceptual work — with no single group claiming to have the final say over the outcome — is the most productive form of consensus building. It is to be hoped that at a time when the IMF warns against new sovereign debt problems[56] and at the same time declares itself to be unable to work on a new SDRM,[57] even the Washington institution will see multi-stakeholder processes as an opportunity to bring about progress.

56. IMF (2015): *Macroeconomic Developments and Prospects in Low-Income Developing Countries: 2015.* Washington, DC: International Monetary Fund; available at: https://www.imf.org/external/np/pp/eng/2015/111915.pdf (last accessed on 8.5.2017).

57. Press Conference of Managing Director Christine Lagarde at the 2014 spring meetings.

Annex

Caribbean Group

	Antigua & Barbuda	**Barbados**	**Dominica**	Grenada	St. Kitts & Nevis	St. Lucia	**St. Vincent & the Grenadines**	Total	Total: Priority countries
Public debt (US-$)	1.304.000.000	4.741.380.000	317.500.000	894.034.000	407.763.000	1.164.010.000	540.200.000	9.368.887.000	6.903.080.000
External Debt (US$)	441.200.000	4.490.000.000	314.211.000	685.793.000	187.500.000	529.447.000	338.678.000	6.986.829.000	5.584.089.000
Public Debt/GDP	104.4	104.9	82.4	91.4	**67.8**	**79.1**	**76.6**	–	–
Public Debt/ Public Revenue	474.0	269.0	237.0	369.0	186.0	298.4	290.0	–	–
External Debt/GDP	41,1	**105,5**	**63,2**	72,6	25,9	37,4	45,2	–	–
External Debt/ Export Earnings	**87,9**	282,5	145,1	280,4	73,2	77,8	170,3	–	–
External Debt Service/ Export Earning	17,2	6,6	10,8	11,4	11,3	10,6	17,2	–	–
IMF assessment of risk of LIC/SIDS debt distress	(not PRGT eligible)	(not PRGT eligible)	high	in debt distress	(not PRGT eligible)	moderate	high	–	–
ej-risk assessment: first quadrant	yes	yes	yes	no	no	no	yes	–	–
Common reduction factor	12,8	62,1	36,7	–	27,9	38,1	36,0	–	–
Maximum nominal debt relief	56.432.558	2.787.630.332	115.343.278	–	113.738.047	442.941.858	194.641.253	3.710.727.328	3.154.047.422

All data refer to end-2015.
Bold Countries indicate Priority Countries
Bold indicators are those on which the common reduction factor is based.

Climate Change Group

	Public Debt (US-$)	External Debt (US$)	Public Debt / GDP	Public Debt / Public Revenue	external debt / GDP	External Debt / Export Earnings	Total Debt Service / Export Earnings	IMF assessment of risk of LIC/SIDS debt distress	ej-risk assessment: first quadrant	Common reduction factor (%)	Maximum nominal debt relief
Afghanistan	1.379.000.000	2.488.551.000	6,2	24,9	12.6	**164.4**	2.9	high	no	8,8	217.975.270
Angola	59.600.000.000	36.900.000.000	**64,2**	259,2	31.1	80.9	15.6	–	no	23,7	14.110.903.427
Burkina Faso	4.047.350.000	2.626.926.000	32,7	167,2	24.0	102.8	4.4	moderate	no	0,0	0
Burundi	625.980.000	625.980.000	42,4	185,2	20,3	**325,3**	13,5	high	no	53,9	337.332.598
Central African Republic	672.310.000	1.617.003.000	48,5	**338,8**	15.3	–	–	high	no	41,0	275.432.786
Chad	4.686.000.000	661.851.000	42,6	**350,6**	43.8	–	–	high	no	43,0	284.297.663
Congo, DR	7.486.160.000	5.435.280.000	18,8	129,3	16.8	51.9	3.7	moderate	no	0,0	0
Djibouti	748.130.000	1.222.169.000	39,5	107,2	–	**193.4**	7.2	high	no	22,4	274.261.296
Gambia	811.576.000	526.775.000	91,6	**421,9**	–	168,4	–	moderate	yes	52,6	426.851.658
Guinea	3.579.620.000	1.389.380.000	43,0	**279,1**	22.3	57.5	4.1	moderate	no	28,3	1.014.503.554
Guinea-Bissau	617.872.000	314.876.000	52,9	**267,4**	29.9	101.4	0.8	moderate	no	25,2	155.738.866
Haiti	2.485.959.000	2.084.271.000	30,1	156,2	23.5	117.3	2.0	moderate	no	0,0	0
Kenya	35.482.100.000	19.147.781.000	51,3	**263,0**	30.4	177.5	6.8	low	no	24,0	8.499.514.449
Madagascar	3.457.700.000	2.985.339.000	35,5	**300,4**	31.1	148,2	1,7	moderate	no	33,0	1.140.450.329
Malawi	4.488.680.000	1.735.055.000	82,0	**345,2**	27.3	112.1	4.3	moderate	no	42,1	1.888.054.276
Mali	4.356.000.000	3.690.589.000	30,9	161,7	28,9	**215.6**	12.6	moderate	no	30,4	1.122.925.039
Mauritania	4.302.816.000	10.055.525.000	**91,2**	311,9	69.5	236.7	9.5	high	yes	46,3	1.990.996.000
Mozambique	10.363.000.000	3.668.347.000	**86,0**	306,8	28.9	146.3	4.2	moderate	yes	54,7	5.663.500.000
Niger	3.412.266.000	2.891.867.000	45,1	190,5	40.8	**242.6**	7.5	moderate	no	61,7	1.785.245.895
Papua New Guinea	6.095.200.000	20.030.961.000	30,6	167,3	**147,6**	205.6	11.3	low	no	66,1	13.245.405.106
Sierra Leone	1.878.582.000	1.378.145.000	43,8	**279,6**	31.4	63,1	3,2	moderate	no	28,5	534.818.052
Solomon Islands	125.454.000	207.463.000	10,3	22,4	18.0	35.9	2.4	moderate	no	0,0	0
Togo	2.815.960.000	1.056.055.000	62,3	**285,7**	29.1	63.2	3.5	moderate	no	30,0	844.689.436
Yemen	20.897.110.000	7.287.189.000	66,7	**516,6**	22,0	385.6	18.8	moderate	yes	61,1	12.768.047.500
Total	184.414.825.000	127.538.827.000	–	–	–	–	–	–	–	–	66.580.943.198
Total Priority Countries	34.122.922.000	24.485.043.000	–	–	–	–	–	–	–	–	16.575.194.770

All data refer to end-2015.
Bold Countries indicate Priority Countries
Bold indicators are those on which the common reduction factor is based.

Debt Risk Matrix

Value	▼▼▼▼▼	▼▼▼▼	▼▼▼	▼▼	▼	–	▲	▲▲	▲▲▲	▲▲▲▲	▲▲▲▲▲
15					Jamaica						
14										Gambia	Bhutan
13											
12				Grenada					El Salvador	Croatia, Ukraine	Albania, Cabo Verde, Mozambique
11						Sao Tome and Principe		Cyprus	Lebanon		Kyrgyz Republic
10								Saint Vincent & the Grenadines			Armenia, Brasilia
9							Lao	Bosnia and Herzegovina, Mauritius, Serbia	Antigua and Barbu-da, Tonga, Uruguay	Mongolia	Kazakhstan
8				Belize			Zimbabwe	Nicaragua, Venezuela	Dominica		Ghana, Montenegro
7						Tadzhikistan		Pakistan	Sudan		Colombia, Samoa, Tunisia
6								Eritrea, Rumania	Bulgaria, Malawi	Panama, Papua New Guinea, Republic of the Congo	
5						Turkey			Saint Lucia, Libya	Bahamas, Domini-can Republic, India	Angola, Costa Rica, Honduras, Kenya, Morocco, Macedonia, Zambia, Senegal, Belarus
4				Seychelles				Vietnam		Central African Republic	Niger
3	Guinea			Guyana, Maldives		Bangladesh	Guinea-Bissau, Madagascar		South Sudan		Indonesia, Mexico, South Africa, Tanzania, Togo
2	Saint Kitts and Nevis			Côte d'Ivoire, Djibouti		Sierra Leone			Burundi	Cambodia	Ecuador
1				Nepal		Afghanistan				Gabon, Chad	Ruanda
0	Comoros, Solomon Islands			Democratic Republic of the Congo, Mar-shall Islands		Micronesia, Vanuatu			Burkina Faso, Guate-mala, Kiribati		Haiti, Cameroon, Mali

The matrix provides an overview of where individual countries stand with regard to the entirety of their debt indicators as of end-2015, as well as their dynamics between 2011 and 2015. The higher on the y-axis a country is located, the more indicator thresholds it has breached in 2015. As we consider five indicators with three threshold values each, the highest score a country can show is 15. The vertical axis shows how indicators have changed between 2011 and 2015. On the extreme right we have countries where all indicators have worsened by at least 10 per cent between 2011 and 2015; next to it, with a score of plus four, we have countries where all but one indicators have worsened by at least 10 per cent, while the remaining one has stayed within the +/- 10 per cent range. On the extreme left, we have mirrored the corresponding improvement scenarios, while all other columns show a mixed picture- The matrix is no substitute for a proper debt sustainability analysis, but is intended to help identify countries or groups of countries, which could be considered for other regional or thematic debt relief initiatives beyond the two groups discussed in this paper.

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