



Hope for Indebted States

Will the United Nations be Successful in Establishing a Sovereign Debt Workout Mechanism?

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- The United Nations asserted a leading role in coping with sovereign debt crises for the first time in September 2014. The majority of the developing and newly industrialising countries prevailed in the General Assembly of the United Nations in the face of opposition from advanced industrialised countries – including the United States, Germany and Great Britain.
- The confrontational resolution adopted by the majority is an expression of the considerable frustration in the Global South over the existing regime for dealing with debt crises. This regime, of which the industrialised countries are the architect, is held to be inefficient and unfair.
- The industrialised countries now have the opportunity up until September 2015 to abandon their efforts to block the move and get involved in the process in a constructive manner with their own positions.

On 9 September 2014 the General Assembly of the United Nations (UN) resolved with a considerable majority to »draft and adopt (...) a multilateral legal framework to restructure sovereign debt«. And what is more: it resolved that this restructuring is not to take place for instance in a procedure lasting indefinitely and possibly taking several years, but rather in the ongoing session, i. e. by the end of September 2015.

This resolution provides a new dimension to the debate over how to cope with debt crises that has been raging ever since the eruption of the »Third World debt crisis« in the 1980s: how can defaulting countries achieve a new beginning in an efficient way based on due process of law, just like is also possible for business enterprises in insolvency proceedings?

This question is no less pressing today than it was 30 years ago. The Euro crisis is still a long shot from having been resolved and debt levels of several European states remain alarming. The level of indebtedness on the part of numerous developing and newly industrialising countries has also once again reached unsettling dimensions. According to estimates by the International Monetary Fund (IMF), 15 countries with low incomes or having the status of »small island developing states« (SIDS) exhibit a »high« risk of becoming excessively indebted once again. Another 29 countries are considered to pose a »moderate« risk, whereby a »high« risk already means that under the IMF scenario assumed as probable a debt crisis will indeed take place. This risk is »moderate« if one of the additional crisis scenarios mapped out by the IMF forecasts the occurrence of a sovereign debt crisis.

The resolution from 9 September is more than the next round in a debate that has been raging for over thirty years. This is illustrated by the arguments forwarded by eleven countries that voted against the G77's draft resolution. Their core argument is that such debates should not take place in the UN, but rather in the IMF – where a proposal along these lines by the Washington institution in response to Argentina's default was discussed intensively twelve years ago, although ultimately without producing any results. This is precisely what the G77 wanted to avoid experiencing again and why it deliberately dispensed with a »consensus« – a term which does not crop up anywhere – that reforms should be decided within the framework of the financial architecture in Washington and not in New York.

The Path to the UN Resolution

The resolution submitted at the beginning of August by the group of »G77 & China« – i. e. by almost all of the developing and newly industrialising countries – met with surprise and disbelief on the part of the two groups of industrialised countries within the UN system. Even though they have been requested to take part in several rounds of debate over the initiative since then, the industrialised countries have refused to do so almost without exception. The G77 reacted to this in two ways:

- It unilaterally watered down the draft text, which had initially aimed at creating a »convention« binding under international law, by merely making the objective the creation of a »legal framework«;
- and they adopted the resolution on 9 September with their own majority, i. e. with 124 versus 11 votes and 41 abstentions.

In formal terms the decision means that the General Assembly now has a self-appointed mandate as well as an obligation to submit a proposal in the said period of time. It is highly unusual for such a decision to be adopted by a majority in the UN General Assembly. It would be more in tune with the style of the global organisation to discuss the issue in working groups and informal meetings until a formulation is found by consensus – as the G77 was also seeking.

Generally speaking, wordings were accordingly to be couched in general terms, not very binding and above all not associated with an obligation to act within a prescribed period of time. The industrialised countries expected that the initiators would not depart from this custom. It was consequently hoped that the industrialised countries' stubborn refusal would cause the whole thing to run out of steam on its own. This calculation on the part of the »North« did not materialise, however, which is more than remarkable and can only be understood in the light of several developments in the area of sovereign debt at present.

Three more recent events have by the same token perceptively played a role: first of all is the refusal of the US Supreme Court to review a ruling by a New York court in favour of the hedge fund NML Capital in an action against Argentina following appeal. NML Capital is one

of the so-called »vulture funds«, whose business model revolves around buying debt cheap from crisis-ridden countries and then taking legal action to collect the full amount on these claims as soon as these countries recover. The New York judge Thomas Griesa applied a very ideosyncratic interpretation of the pari-passu clause that is frequently contained in bond and security agreements (which is controversial among jurisprudence experts) in order to interrupt Argentina's flow of payments with its legitimate creditors as long as Buenos Aires does not service the »vulture funds« that initiated the action in the full amount. The »vulture funds« had bought old debt of Argentina from the period before the debt swap in 2005 for about 20 cents on the dollar. This ruling produced an uneasy feeling among the countries of the Global South, which had been issuing treasury bonds on New York exchanges on a large scale for many years. A mechanism for sovereign defaults based on due process of law would hence offer a solution because it would encompass all debt, in this way being able to prevent »vulture funds« from profiting from debt crises at the expense of other debtors.

Less salient but no less important have been two additional events: first of all a decision by the IMF management to stick to the line laid down by its rich member countries and not itself to pursue any projects to surmount debt crises that are any more ambitious than the insertion of collective action clauses in future securities agreements. At the beginning of 2013 the IMF had submitted a remarkably open and self-critical stock-taking of existing proceedings aimed at overcoming sovereign debt crises. However, it left unresolved in what manner the need for reform that was being clamoured for should be met. At a press conference that took place in connection with the IMF/World Bank 2014 spring meetings, the director of the Fund, Christine Lagarde, made it clear that the ambitions of the institution would be limited to these »contractual« reforms.

The third event was the G77 and China's Summit held in Santa Cruz, Bolivia, in June 2014. The meeting, skilfully orchestrated by Bolivian President Evo Morales, was a rare opportunity for this diffuse group of countries to tie together two other strands – Argentina's threat and the refusal of the IMF to thwart a danger to the poorer countries – in a joint initiative by the »Global South«. The most important formulations of the UN resolution from 9 September are already to be found in the Summit's

final declaration. The strong cohesion of this group of countries, including the heavyweight BRICS countries, in starting their own initiative can scarcely be understood without the accord forged in Santa Cruz – apparently below the radar of the Western powers.

The Stance of the Industrialised Countries

Germany's stance on the draft resolution has been characterised by two fundamental positions:

- Negotiations on issues relating to the global financial architecture are generally not to be negotiated in the United Nations, but rather solely in the IMF.
- With the sought-after resolution, Argentina instrumentalised the global organisation in an unallowed way in its dispute with the »vulture funds«.

The ministries involved in the issue (the German Federal Ministry of Finance, the Federal Ministry for Economic Affairs, the Federal Ministry for Economic Cooperation and Development and the Federal Foreign Office) definitely do not share the same view on these arguments. The Federal Ministry of Finance is in charge of spelling out the substantive position, however, and those ministries representing the more open stances are responsible for working out the details of the position were not prepared to formally state that there was disagreement. In the event of disagreement between ministries, Germany would not have voted against the resolution, and would instead have abstained along with the majority of European states.

Among those European countries abstaining were numerous Eastern European states which preferred to avoid taking up a position on such a controversial issue. Then came the Italian presidency of the EU, which did justify abstention in the name of the EU, although Italy itself abstained, and the Netherlands, which brought the Permanent Court of Arbitration in Den Haag as headquarters for an institution like the resolution is seeking into the discussion.

Two industrialised countries should actually have supported the G77 initiative in its essence, as they had made similar proposals themselves in the last few years. They nevertheless did not vote in favour of it because they (a) had their problems with the language and philosophy

of the G77 initiative and (b) did not want to completely discard their informal solidarity with European states opposed to the initiative – including in the interest of future compromises.

These countries were:

- Norway, which has advanced to become the engine in the international discussions over how to cope with debt crises in the last few years and has not bid farewell to these ambitions following the switchover from a centre-left to a centre-right government, and
- Switzerland, whose *Ständerat* (small chamber of Parliament) had obligated the *Bundesrat* (the government) to support initiatives for the creation of an orderly sovereign insolvency procedure.

Among the eleven countries voting against the resolution, the USA and Great Britain set the tone. The USA actually should not have had any problem with Argentina's role as protagonist, which Germany objected to, as the US government had come down on the side of Argentina in an *amicus curiae* letter to the Supreme Court. London and Washington's action was therefore guided by the effort to preserve the monopoly of the IMF, which is dominated by the industrialised countries.

Both arguments are on shaky ground:

- Formally speaking, the IMF is a sub-organisation of the United Nations. Both are linked together through a complex web of agreements that among other things prohibit any orders being given to the other respective organisation. The IMF has far-reaching powers to spell out rules of the game for the international financial system based on its Articles of Agreement. It is not laid down anywhere, however, that it has a monopoly on this. On the other hand, agreements that are generally binding under international law can be made under the auspices of the UN. There is no reason why this should not also apply to ways of dealing with sovereign defaults.
- The justification stated for this – that Argentina is abusing the UN General Assembly in the context of a court ruling issued against the country – is not convincing if only because it is difficult to see how a UN process that has just begun is supposed to influence a ruling that has already been handed down by the high courts in the US. Argentina's foreign minister, Héctor Timerman, thus made it clear at a press conference held on 10 September it was not Argentina

that is at stake, but rather »everyone that finds themselves in the same unfortunate situation as us in the future«.

Rejection of New York as the birthplace for a sovereign insolvency proceeding – which everyone considers desirable – has also been justified with the argument that proceedings in Washington, i. e. at the IMF, would be in the domain of ministries of finance and central banks, whereas in New York these proceedings would take place under the auspices of foreign ministries, which actually do not have the required competence in the field. Why ignore the »Washington competence«, it is argued, which has been present for so long, and reinvent the wheel in New York?

A host of statements made at the annual IMF meeting – among them the communiqué by the G24, i. e. the representatives of the developing and newly industrialising countries at the IMF and World Bank – only a few weeks after the UN decision on 9 September show, however, that the issue is by no means a »question of competence«: The ministers of finance and heads of central banks in the »South« expressly supported the process commenced by their colleagues in foreign ministries in New York. They thus apparently consider the »incompetent« UN to offer fertile ground for the development of a proposal in comparison to the G7-dominated IMF.

The Road Forward

At the beginning of November the countries in the G77 rejecting the draft resolution submitted a compromise proposal. It provided for the next resolution in line on the modalities of the future procedure to delete the term »legally binding« from the text laying down the purpose of the sought-after »legal framework«. The proposal was interesting in that it allowed a more informal result to be sought such as, for instance, the creation of a contact office mandated by the UN for countries requiring debt rescheduling instead of a difficult-to-achieve legal framework. This option was forwarded in November by *erlassjahr.de* and other NGOs. The interest of the G77 in the compromise proposal dissipated immediately, however, when the rich countries underscored that they would definitely not consent to the compromise that they had proposed themselves, and would instead merely abstain. A »modalities« paper submitted by the G77

was thereupon accepted in the second committee of the UN General Assembly with a majority similar to that in September (128:16:34) on 5 December. The main actor is accordingly to be an ad hoc committee with equal representation of countries from the North and South that is still to be set up by the end of the 69th session. The committee is to meet for three days each in early February, in May and in June/July 2015 and hear both the delegations as well as relevant stakeholders, including civil society organisations. Such an open and transparent process is one of the strengths of the UN system in comparison to other inter-state organisations. A (modest) budget for the overall process has been adopted in the same constellation in a third reading at the end of December.

Non-governmental organisations like *erlassjahr.de*, which have been working for many years in an international network towards the creation of a Sovereign Debt Workout Mechanism, will be able to contribute their expertise there. Whether countries will indeed be able to cope with their insolvencies in an orderly manner beginning in September 2015 will depend on whether the protagonists of the »legal framework« are successful in developing a proposal that at the same time portends perceptible progress in comparison to the »non-system« prevailing so far and is at least acceptable to a significant number of those countries showing reluctance so far.

The political consensus is at the same time expressly more important than rapid implementation of a concept in international law. After all, management of sovereign debt crises has at best only partly been based on binding international law, instead relying for the most part on informal fora such as the Paris Club, which does not even have the status of a separate legal entity, or the power of the international financial institutions IMF and World Bank to muscle things through. With regard to legally binding power, standards for a new scheme to meet are therefore not very high. This does not, of course, mean to suggest that a binding framework should not be aimed at.

It is furthermore of importance that nobody in New York needs to reinvent the wheel of orderly sovereign insolvencies. The United Nations Conference on Trade and Development (UNCTAD) has been working on this topic since 1986 and has now set up a working group which intends to submit a roadmap for future sovereign

insolvencies in March 2015. The United Nations Department of Economic and Social Affairs (UNDESA), which is in charge of the financing-for-development process, has been working for some time on proposals along these lines. The Sovereign Debt Restructuring Mechanism (SDRM), the IMF proposal for a sovereign insolvency proceeding launched in 2001, contains elements that could be used for an »official« UN mechanism. And finally, numerous economic policy thinktanks have made proposals of their own since the Euro crisis. One could almost surmise that it is the plethora of proposals that will pose more problems for the future authors in New York than the need to draft a solid as well as progressive paper in a relatively short period of time.

The resolution does not lay down hardly any requirements at all regarding content. If one examines the problems that led to its adoption, however, then at least three elements need to be assured in the proceeding in order to achieve real progress compared to the status quo:

- A reformed proceeding must relate to all claims against the indebted country instead of forcing it to negotiate with various creditors in different forums, as has been the case so far.
- The IMF and World Bank monopoly regarding interpretation of the need to ease debt obligations (debt sustainability analyses) must be replaced by an independent analysis.
- Instead of creditors deciding over their own matters as has been the case down to the present, the decision on debt cancellation, restructuring or the further servicing of debt must be made on a non-partisan basis.

Aside from these fundamental aims and objectives, the G77 would be well advised to be as flexible as possible in designing future proceedings. The process that is commencing now offers a major opportunity to resolve a problem weighing on international financial relations since 1982. A systematic blocking action by the eleven countries rejecting this could cause these hopeful beginnings to become bogged down in mundane proceedings and financing issues. This makes it all the more important for a broad alliance made up of civil society, parliaments and scholarly research – particularly in the industrialised countries – to work to ensure that the opportunity is seized to create a sovereign insolvency proceeding with the backing of the world community.



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