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The Advantages of an Ex Ante Approach

by

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The Danger of Higher Interest Rates

Inherent in the Ex Post approach to labeling debt illegitimate

- (From commercial lenders)
- Theory tells us that “the” interest rate is determined in a wider market, so that in the long run lenders will expect a competitive return in the sovereign debt market
- It follows that any gains yielded by default, even default disciplined by an agreed process, will be paid for by other borrowers, not by banks.

The Attraction of an Ex Ante Approach

- Lenders would know in advance whether a regime was judged legitimate by the international community
- Hence a legitimate regime might even see a *fall* in interest rate, to the extent that the market judged there was some prospect of default under the present regime
- Still avoids the spectacle of future “democratic South Africas” paying to service loans that were taken out to suppress the majority
- (But it is true that it cannot resolve inherited debt problems).

Enforcement Mechanism

- Primarily by making lending unprofitable to regimes that have been proscribed ex ante
- By the countries that host sovereign debt agreements making it legally impossible for lenders to enforce terms of proscribed debt contracts
- Secondarily by donors threatening to not aid any country that sought to service proscribed debt
- In practice the critical decision would be to declare a country proscribed.

Who Would Be Proscribed?

- Two categories of countries have been discussed
- Countries judged guilty of suppressing a large part of the population (like apartheid-era South Africa or Mobutu's Zaire)
- Countries in which there is an illegitimate regime change (Honduras being a good current example).

What International Agreement?

- Discussion in CGD study-group has mainly centred on the relative merits and feasibility of a formal international agreement versus informal action by a small group of countries, or the possibility of a compromise
- A formal international agreement (probably within the UN) is regarded as ideal, but is it feasible?
- Alternative is a small group of countries: countries in which debt is issued (and whose legal systems are used) are essential, also desirable to have range of lending and borrowing countries to give decisions of the group some legitimacy
- A compromise might use a small implementing group but rely on the decisions of regional organizations, e.g OAS on Honduras.

The Decision to Proscribe

- Depends critically on the answer to the previous question
- Under a formal international agreement, the decision would be made by whatever organ was so deputed; danger of it being unable to reach agreement
- Under an informal agreement, US, UK, other advanced countries with potential attachable assets (EU, Japan, Switzerland, Canada, Australia), major emerging markets desirable.