UNCTAD Debt Workout Mechanism (DWM):

Working Group Meeting no 3

19 March 2014

CONCLUDING SUMMARY

The purpose of the third WG on the DWM was to discuss the potential role and use of debt indicators prior and throughout a debt workout mechanism. Following the WG identification of concrete problems encountered in past and present debt restructurings such as procrastination, creditor incoordination and holdout litigation and forum fragmentation, the meeting focused on the use of indicators in providing some objective guidance.

1. Legal Principles and Implications for the Design and Use of Indicators in a DWM

Most existing debt schemes rely on economic indicators that derive legal relevance from their operational use as a determinant for lending decisions and conditionalities as well as monitoring and sanctioning procedures**.** Four general principles can be reconstructed inductively and deductively from existing sources of law: efficiency and sustainability, transparency, ownership, and human rights and social protection.

Based on these principles, the WG discussed the use of indicators in signalling and monitoring sovereigns' vulnerability to debt servicing problems and guiding the procedure and content of a restructuring.

- Efficiency and Sustainability: Indicators should not force states into restructuring but be operationalized in combination with qualitative assessments to signal vulnerable debt and contribute to the efficient use of public resources. Relevant actors may further employ indicators to prevent delayed restructuring decisions and to objectify the size of restructuring that is necessary to preclude future debt servicing problems. Given that currently no indicator alone seems to sufficiently meet these objectives, the WG emphasized the importance of not setting for a definite indicator framework but to initiate a public discourse on the review and revision of different indicators.
- The importance of transparency for the use of indicators in a DRM is twofold: Public debt and restructuring procedures may be subject to "restructuring transparency" whereas the underlying data as well as the construction and application of the indicators may be subject to "indicator transparency". Transparency generally serves to improve the quality of information upon which market transactions and restructuring decisions are based, thereby contributing to expedited negotiations and substantiating necessary restructurings to the public. However, it may also increase the risk of excessive market fears of potential debt servicing problems by countries with otherwise sustainable debt positions.

- Ownership: A restructuring decision should be made on the cumulative requirements that the sovereign declare its decision to restructure and its debt be on a vulnerable debt path. Once indicators signal debt fragility, ownership dictates the sovereign's right to invalidate or revoke this presumption.
- Human rights and social protection require states and international organizations to respect, protect and progressively fulfil human rights entitlements enshrined in international treaties. Various indicators are used in the context of these entitlements and substantive human rights obligations are reinforced by other commitments such as the Millennium Development Goals. All creditors, public as well as private, should thus be bound not to request disproportional debt workouts and affiliated adjustment programs which would prevent the debtor state from fulfilling its international human rights obligations.

2. Economic Practicability of the Use of Indicators as an Early-Warning Tool

Given the short-term dynamics and the political, legal and economic sensitivities that surround debt crises, it is extremely difficult to economically establish the inevitability of a debt restructuring. The WG thus considered various aspects of an adequately tuned indicator framework that could signal debt vulnerability at an early stage and initiate enhanced scrutiny.

- As triggering events of debt crises are hard to predict, the economics of debt vulnerability should assess the likelihood of the occurrence of a debt crisis through an early warning indicator, which - in combination with other economic indicators - signals debt vulnerability that may warrant further investigation.
- To prevent indicators from functioning as triggering events themselves, they should be country-specific and provide a value range, rather than one exact and universal threshold, that indicates that a country's debt level may become vulnerable in the medium- or long-run. Not only economic and debt fundamentals but also volatility and historic and optimism bias should be factored into the calculation of this threshold range.
- For indicators to be reliable and gain broad acceptance, it is crucial that they be simple to calculate and understand and constructed from data that can be easily obtained and regularly verified and updated.

3. The Role of Debt Indicators in an International DWM Procedure

The value of indicators relies as much on their intrinsic capacity to signal debt vulnerability as on their acceptance among negotiating parties and the international community. The WG thus agreed that indicators should be embedded in an international mechanism that guarantees the validity, acknowledgement and consistency of the use of indicators.

- To preclude self-fulfilling restructuring needs, indicators should provide input to the broader political discourse, in which indicators and market expectations signal vulnerable debt positions that may trigger additional assessments on the need for restructuring.

- Within this framework, the WG distinguished between three different possible economic and political roles and functions of stakeholders involved in international transactions:
    1. As the value of indicators depends on their broad acceptance, the international community -could provide the indicators with a political mandate that would enhance their effectiveness as an early-warning tool and their authority throughout restructuring negotiations.
    2. To ensure the reliability of the indicators, various international actors may carry the responsibility - alongside the sovereigns themselves - of collecting the data as well as of calculating and interpreting the indicators.
    3. In the case of perceived debt vulnerability, one or several international organizations could engage in enhanced scrutiny and take the lead on further qualitative assessments.
- In relation to the various roles that international stakeholders may play, the WG further emphasized the importance of a public discussion on the institutional and operational characteristics that would allow international actors to reliably construct and interpret indicators and to conduct additional assessments for the verification of the necessity and extent of a restructuring. Furthermore, the WG agreed on the importance of improved transparency, impartiality and inter-institutional cooperation throughout the process.

4. Concluding Remarks

- The design and use of indicators in a DWM may be grounded in four general principles that can be derived from different sources of law: efficiency and sustainability, transparency, ownership, and human rights and social protection.
- Indicators should not replace but contribute to the political debate by 1) indicating potential debt servicing problems and initiating additional assessments and 2) shaping the procedure and content of restructuring negotiations.
- Indicators should be read in conjunction with market expectations and qualitative assessments and provide country-specific ranges based on economic fundamentals, volatility and financial sector soundness. They should be simple, based on easily available data and subject to scrutiny.
- Creditors should be bound to not request disproportional debt workouts and affiliated adjustment programs that would counteract international public interests such as the protection of human rights entitlements and the fulfilment of the Millennium Development Goals.
- The DWM should devote additional analysis to the identification of triggering events that may indicate the emerging need for a debt restructuring.
- Additional discussions may further focus on the institutional and operational requirements of independent bodies as well as the conflict between the concept of impartiality and a country's ownership of the data collection and interpretation process.