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Chapter V

EXTERNAL DEBT AND DEBT CRISES: GROWING VULNERABILITIES AND NEW CHALLENGES

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A. Introduction

The preceding chapters analysed the major weaknesses in the existing international monetary and financial system, which limit its ability to promote and maintain global economic stability. They also constrain the efforts of policymakers, in developed and developing countries alike, to achieve more inclusive and sustainable growth paths. At the macroeconomic level, the current system has failed to substantially reduce volatility in financial markets and to correct persistent global imbalances. In addition to the often high social and economic costs to individual countries, this has also led to the continued accumulation of large external debts. At the microeconomic level, as discussed in the previous chapter, regulation has failed to curb the high risk-taking and procyclical behaviour of various financial institutions, which was at the root of the 2008−2009 global financial crisis. Thus the risk of future financial and debt crises persists.

This chapter addresses a long-standing deficiency in the international monetary and financial system, namely the lack of an effective mechanism to better manage external debt crises. It pays particular attention to sovereign debt, since, as discussed in chapter II, even when financial crises originate in the private sector, as is often the case, they usually result in public overindebtedness and a prolonged period of economic and social distress.[1]

In the run-ups to the last eight major crises in emerging economies (beginning with Mexico in 1994, followed by Thailand, Indonesia, the Republic of Korea, the Russian Federation, Brazil, Turkey, and finally, Argentina in 2001), sovereign debt was a problem only in four economies − Argentina, Brazil, Mexico and the Russian Federation. But in almost all these instances, sovereign debt increased abruptly with the crisis. Several factors contributed to this increase. In most of these economies, a major share of private debt, both domestic and external, was socialized through government bailouts. Public funds were also used for recapitalizing insolvent banks and assuming the costs of devaluations that otherwise would have had to be borne by the private financial and non-financial sectors. And, following these crises, fiscal revenues were lower and interest rates on the public debt rose. Much the same pattern was repeated more recently in Ireland and Spain during the eurozone crisis.

The next section of this chapter provides a brief introduction to the challenges raised by external sovereign debt. This is followed by an overview of recent aggregate and regional trends in developing countries' external debt volumes and composition (section C). Section D summarizes basic characteristics of existing financial and debt crises in developing economies, in general, and examines historical approaches to sovereign debt resolution, in particular. Section E analyses current proposals for reform of the present, fragmented system of sovereign debt resolution.

B. Sustainability of external debt: Main issues

External debt is not a problem in itself; indeed, debt instruments are an important element of any financing strategy. But it can become a problem when the foreign borrowing is unrelated to productive investment, or when a net debtor country is hit by a severe shock to its key macroeconomic variables. Under these circumstances, the claims on the debtor can quickly exceed its capacity to generate the required resources to service its debts. If these claims are not matched by new credit inflows (or by higher interest receipts from investments abroad) servicing the external debt amounts to a transfer of resources to the rest of the world, which, if significant, reduces domestic spending and growth, thus further compromising its ability to make payments when they fall due.

External debt instruments are important elements of any financing strategy…

High external debt has diverse causes and varied impacts in different groups of economies. In most low-income countries, it is the result of chronic current account deficits, primarily reflecting limited export capacities and high dependence on imports for both consumption and investment purposes. The bulk of direct debt-generating capital flows to these economies has come from official sources. By contrast, a large proportion of the external debt of middle-income countries has come from private creditors since the mid-1970s as a result of their greater integration into the international financial system, which gives them easier access to international financial markets.

The sustainability of such an external debt burden depends on the relationship between the growth of domestic income and export earnings, on the one hand, and the average interest rate and maturity of the debt stock on the other. Thus, to the extent that foreign capital inflows are used for expanding production capacities – directly or indirectly through improved infrastructure, especially in the tradable sector – they contribute to boosting the domestic income and export earnings required to service that debt. However, external debt has increasingly resulted from private capital inflows that were largely unrelated to current needs for the financing of trade and investment. And as their volume has frequently been very large compared to the size of the recipient economies, such flows have led to asset bubbles, currency overvaluation, superfluous imports and macroeconomic instability, thereby increasing the risk of defaults. They also expose those economies to the vagaries of international capital markets, as they facilitate or even encourage the build-up of external debt during the expansionary phase of the financial cycle, but may easily trigger a debt crisis when there is a sudden stop or reversal of those capital flows.

In addition to these basic macroeconomic relationships, the sustainability of external debt also depends on its structure and composition. The commonly used definition of gross external debt, including in this chapter, adopts the residence criterion, which consists of non-resident claims on the resources of the debtor economy. Specifically, gross external debt here corresponds to the outstanding amount of "liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future, and that are owed to non-residents by residents of an economy" (TFFS, 2013: 5). Other possible criteria to qualify debt as either "domestic" or "external" are whether it is denominated in domestic or foreign currency, the jurisdiction under which debt is issued and where a legal dispute will be settled in case of a default.

When most external debt consisted of loans, as opposed to bonds, the residence, currency and jurisdiction criteria tended to coincide: the lender was a non-resident and the loan was issued in a foreign currency under foreign law. This has changed significantly since the early 1990s. Over the past two decades, increases in the stock of outstanding debt have been accompanied by a process of disintermediation (i.e. a shift in debt instruments from syndicated bank loans to more liquid bond debt). Since bonds issued in local currency and under local law may be held by foreign investors, and conversely, sovereign debt denominated in a foreign currency may be held by residents, a significant share of debt could be considered "external" under some criteria and "domestic" under others.

The amount of debt issued in foreign-denominated currencies could significantly affect debt sustainability. This is because, in order to service such debt, the debtor must not only generate the required income, but also obtain the corresponding foreign exchange. This depends on the state of a country's balance of payments. However, there may be a trade-off between the conditions needed for extracting trade surpluses, on the one hand, and those determining debtors' profits (or primary surpluses in the case of governments) on the other. For instance, domestic currency devaluations and recessionary adjustment policies might be needed to improve export performance and reduce imports, but they will also have the effect of increasing the real value of the foreign-denominated debt and reducing the debtor's income.

… but external debt can become a problem if foreign borrowing is unrelated to productive investment.

In mostly higher income developing countries, a recent trend has been a shift in the denomination of debt from foreign to local currency. This has been made possible largely as a result of a strong expansion of global liquidity and concomitant surges of capital inflows into these economies, reflecting lenders' willingness to assume the exchange-rate risk and operate under local jurisdictions. But in this case, the residence criterion is relevant for debt sustainability, because investments in local bonds and securities by non-residents make domestic debt markets more liquid. Moreover, growing non-resident participation in these markets also means less stability of holdings relative to participation by domestic institutional investors, as the latter are usually subject to regulations that oblige them to hold a given percentage of their assets in local debt instruments. By contrast, when non-resident creditors liquidate their local-currency-denominated debt, they are likely to convert the proceeds into foreign currencies and repatriate their earnings.

Finally, the jurisdiction of debt issuance affects debt sustainability, since it defines the rules under which any disputes between debtors and creditors are negotiated, in particular the extent to which non-cooperative creditors will be allowed to disrupt agreements on debt resolution between debtor States and a majority of their private creditors. More generally, where developing countries' external debt has mostly been issued under foreign jurisdictions as a supplementary guarantee for investors that are distrustful of the judicial system of the debtor country, this has the potential to complicate crisis situations, since the debtor economy may have to contend with multiple jurisdictions and legal frameworks. In addition, countries that have signed international investment agreements, including those providing investor-State dispute settlement mechanisms, may be sued in arbitration tribunals such as the International Centre for Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL). The nature of such arbitration has tended to be ad hoc, and mostly biased in favour of investor claimants. Moreover, it is generally based on a private commercial logic, without consideration for the long-term social and economic impacts on the debtor economy as a whole (Van Harten, 2007; see also *TDR 2014*).

Sovereign debt deserves special attention for a number of reasons. In some instances, governments may encounter difficulties in servicing the external debts they have incurred to finance their public expenditures. In times of easy and cheap access to credit, they may underestimate the risk of their exposure to the volatility of the international financial system and to financial shocks arising from monetary policy changes abroad. In many other instances, however, the initial cause of a sovereign debt crisis is the imprudent behaviour of private agents, on both the borrowers' and the creditors' sides. In principle, private debtors' defaults on their external debt fall under the insolvency law of the jurisdiction where the debt was incurred. This legal framework typically provides for a certain degree of debtor protection and debt restructuring (with or without a partial debt write-off), or for the liquidation of a debtor's assets in case of bankruptcy. But when a wave of private defaults threatens to disrupt the financial system, the public sector often assumes the private debt, especially that of large banks, and as a consequence becomes overindebted itself (see chapter II of this *Report*).

Sovereign debt crises are often caused by private agents' imprudent behaviour, on both the borrowers' and the creditors' sides.

However, sovereign debt problems are not subject to the legislation that governs private defaults. They therefore necessitate specific treatment, not least because governments and public administrations are tasked with the role of providing public goods through appropriate macro- and microeconomic policies designed to achieve long-term development objectives. Therefore, any impediment to fulfilling these duties due to debt overhang or to conditionalities associated with support to debt restructuring would have significant social, economic and political impacts. This raises the question of how best to approach sovereign debt restructurings in an increasingly globalized economy.

Concern about the lack of a resolution mechanism for external sovereign debt is not new.[2] Since the early 1980s UNCTAD's *Trade and Development Reports* have repeatedly argued for replacing creditor-led, ad hoc and arbitrary debt workout mechanisms, both for official and commercial debt, with statutory mechanisms that would permit an impartial assessment of a country's debt situation, and promote fair burden-sharing and a restoration of debt sustainability. *TDR 1986* stated: "The lack of a well-articulated, impartial framework for resolving international debt problems creates a considerable danger … that international debtors will suffer the worst of both possible worlds: they may experience the financial and economic stigma of being judged de facto bankrupt … At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code". As with other needed reforms of the international monetary and financial system, there may be a trade-off between desirability and feasibility, at least in the short term. Consequently, a range of options to deal with sovereign debt problems needs to be considered.

C. Trends in the volume and composition of external debt

1. *Evolution of external debt in developing and transition economies*

Measured in nominal terms (and following the residence criterion explained above), the external debt of developing countries and transition economies has displayed a rising long-term trend. With the exception of Africa, which remained a less attractive market for private investors and greatly benefited from debt reduction programmes, all other regions exhibited a significantly higher debt stock in 2013 than in the 1990s (chart 5.1). This was not a steady trend, however: Latin America and South-East Asia – the two developing regions most integrated into the international financial system – had relatively stable external debt levels between 1997−1998 and 2006−2007. This was the result of their own debt crises in the second half of the 1990s, which created a temporary restriction on their access to new private foreign credit. But it was also partly due to their subsequent efforts to reduce their dependence on capital inflows by avoiding recurrent current account deficits, or even generating significant surpluses. In this regard, they benefited from the real devaluation of their currencies during their crises and, in some cases, from gains in their terms of trade after 2003. Since the 2008 global financial crisis, however, the stock of their external debt has been rising again, in some cases dramatically, as a result of both worsening current accounts and renewed inflows of foreign capital driven by expansionary monetary policies in developed countries.

The ratio of external debt to gross national income (GNI), declined at varying rates in all developing regions from the late 1990s until the 2008 crisis (chart 5.2), thanks to favourable macroeconomic circumstances and robust economic growth. The biggest reduction in that ratio occurred in Africa, where it fell, on average, from more than 100 per cent in 1994 to below 20 per cent in 2013. In addition to growth acceleration in the 2000s, this region benefited more than any other from official debt relief programmes. However, after 2008 this trend came to a halt, with the ratio of debt stock to GNI rising slightly again. In the transition economies, external debt stocks have gradually increased from their low base of the early 1990s to reach about 60 per cent of GNI in 2013 if the Russian Federation is excluded, and only 15 per cent of GNI if it is included.

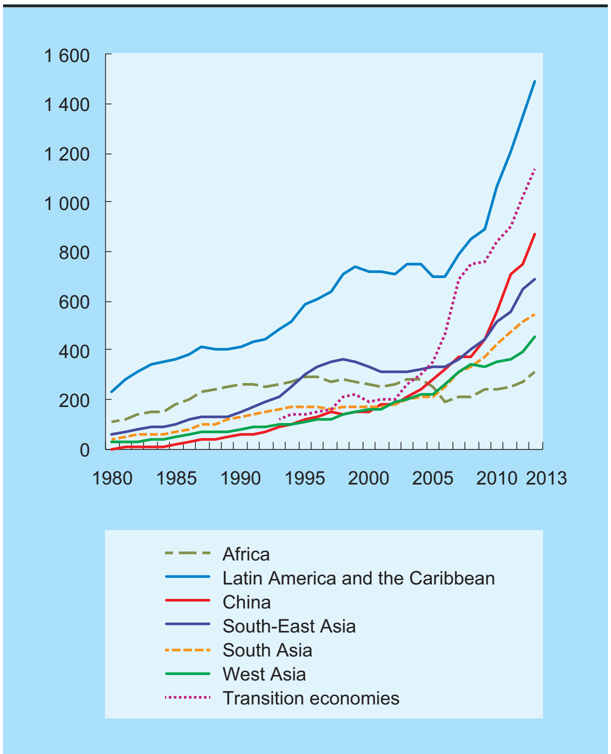
This overall reduction in the relative size of external debts, combined with overall falling interest rates on external debt since the late 1990s, largely explains the diminishing weight of interest payments as a share of exports in all developing regions. In Africa, this share fell from 13 per cent, on average, during the 1980s to around 1 per cent in 2012–2013, in South-East Asia and South Asia it fell from 11 per cent to less than 2 per cent, in West Asia, from 18 per cent to 6 per cent, and in Latin America, from 28 per cent to 6 per cent over the same period (chart 5.3).

As a result, developing countries, including emerging economies, faced the global financial crisis with relatively strong public sector balance sheets and historically low levels of external debt, which helped them, initially, to recover well from this shock. They also became attractive destinations for capital in search of higher returns than those available in the developed economies. This apparent macroeconomic robustness and stability, was,

Chart 5.1

EXTERNAL DEBT, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013

(Billions of current dollars)



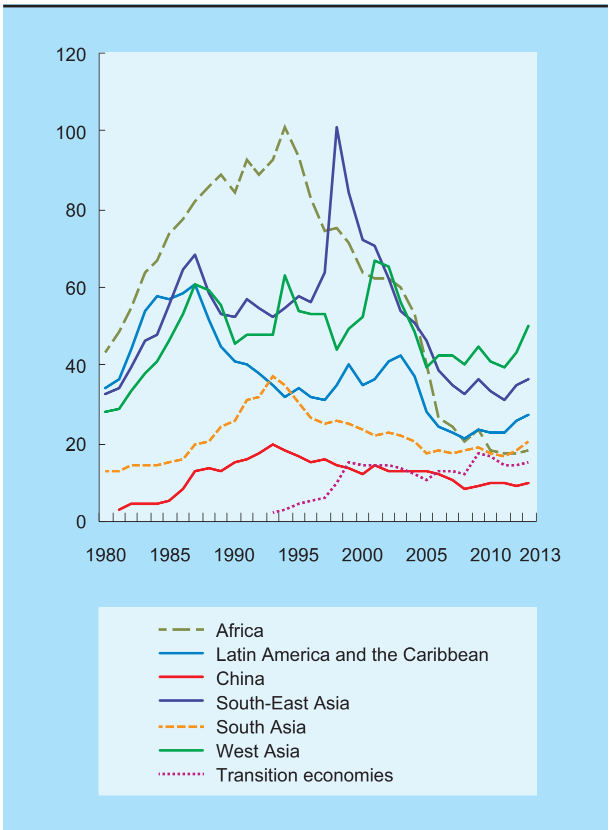
Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators* database; and national sources.

Note: Aggregates are based on countries for which a full set of data were available since 1980 (except for the transition economies where the cut-off date was 1993). Africa comprises Algeria, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, the Congo, Côte d'Ivoire, the Democratic Republic of the Congo, Djibouti, Egypt, Ethiopia, Gabon, the Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Somalia, Sudan, Swaziland, Togo, Tunisia, Uganda, the United Republic of Tanzania, Zambia and Zimbabwe. Latin America and the Caribbean comprises Argentina, Belize, Bolivia (Plurinational State of), Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Peru, Saint Vincent and the Grenadines and Venezuela (Bolivarian Republic of). South-East Asia comprises Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines and Thailand. South Asia comprises Bangladesh, India, Iran (Islamic Republic of), Maldives, Nepal, Pakistan and Sri Lanka. West Asia comprises Jordan, Lebanon, Syrian Arab Republic, Turkey and Yemen. Transition economies comprise Albania, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, the Russian Federation, Serbia, Tajikistan, the former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine and Uzbekistan.

Chart 5.2

EXTERNAL DEBT STOCK AS A PROPORTION OF GNI, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013

(Per cent)

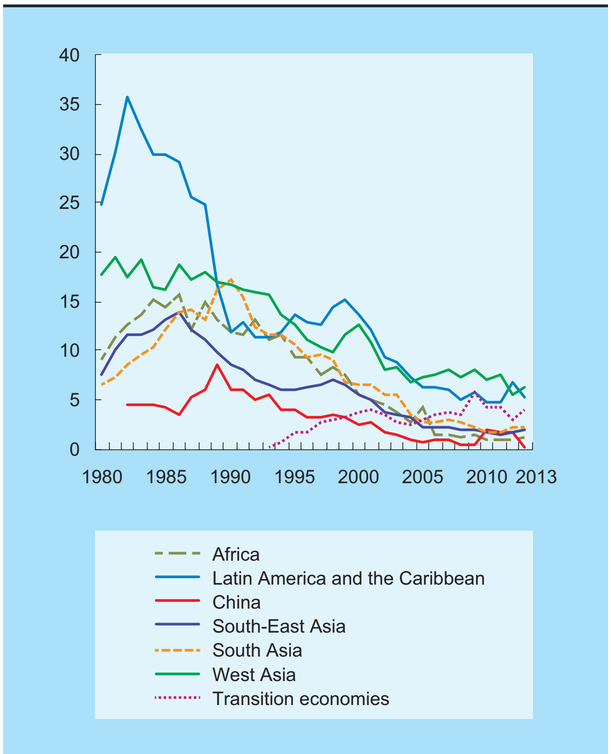


Source: UNCTAD secretariat calculations, based on *UNCTADstat*; World Bank, *World Development Indicators* database; and national sources.
Note: See chart 5.1. Regional aggregates refer to the same countries as in chart 5.1, except for Ethiopia and Yemen, for which GNI data were not available.

Chart 5.3

INTEREST PAYMENTS ON EXTERNAL DEBT AS A PROPORTION OF EXPORTS, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013

(Per cent)



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators* database.
Note: Regional aggregates refer to the same countries as in chart 5.1, except for Djibouti, Ethiopia, Guinea, Guinea-Bissau, Guyana, Haiti, Iran (Islamic Republic of), Lao People's Democratic Republic, Lebanon, Paraguay, the Russian Federation, Sao Tome and Principe, Somalia, Syrian Arab Republic, Thailand, the United Republic of Tanzania and Yemen, for which data were not available.

however, short-lived: recent episodes of turmoil in international financial markets – triggered by expectations of a winding down of quantitative easing in the United States and of a normalization of interest rates there – have adversely affected emerging economies (UNCTAD, 2014). More generally, the recent excessive increase in liquidity in international financial markets that remains largely unrelated to long-term development finance, combined with rising foreign-currency-denominated private sector indebtedness, has increased developing countries' exposure to the volatility of international financial markets.

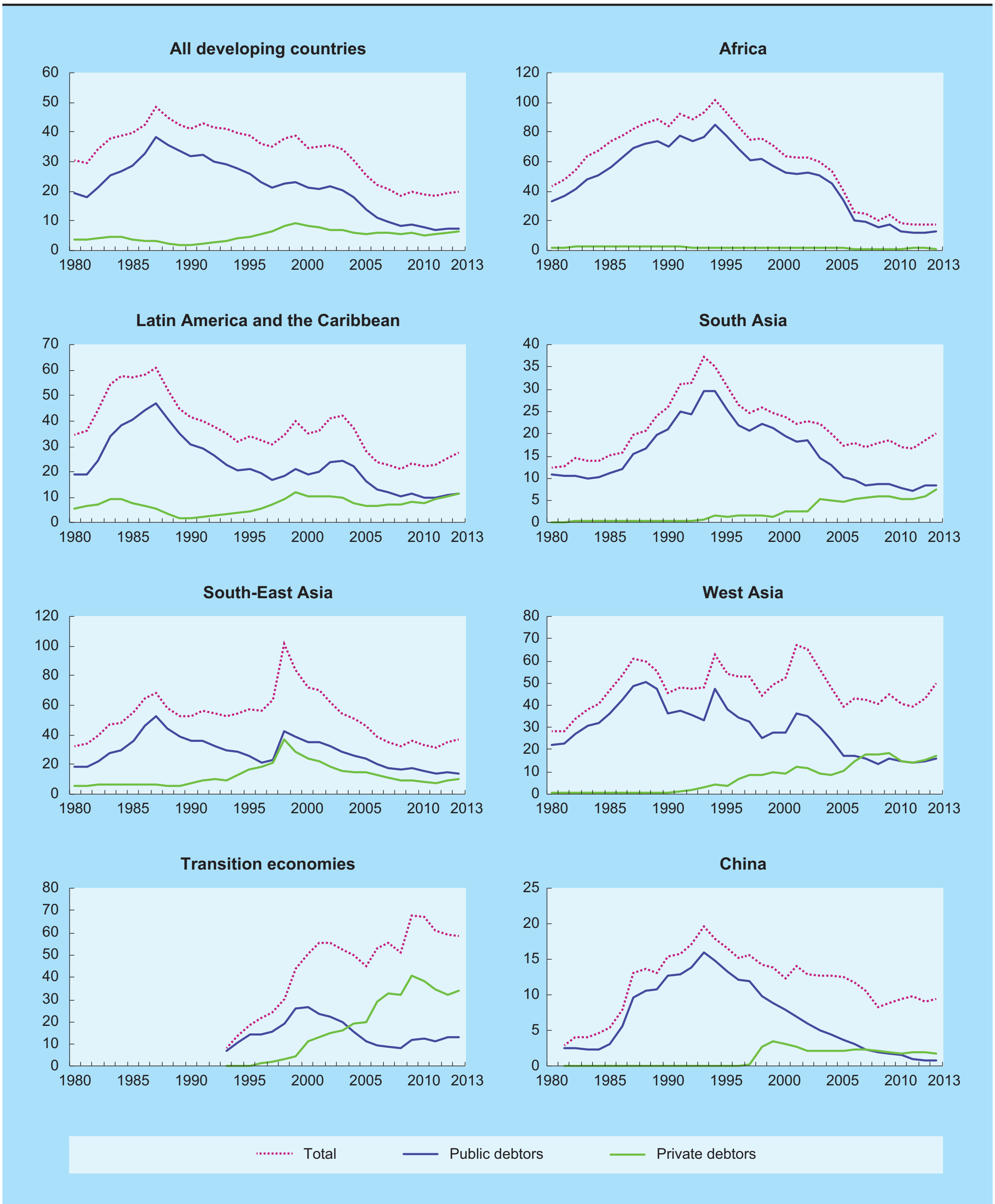
2. *Public and private borrowing and lending*

The relative share of external debt owed by public and private debtors has an important bearing on debt sustainability.[3] Historically, public debt constituted the bulk of external debt in developing countries. In 2000, for instance, its share in long-term external debt stocks of all developing countries was 72 per cent, but by 2013, this share had declined to nearly half of the total stocks (chart 5.4).

Chart 5.4

EXTERNAL DEBT BY TYPE OF DEBTOR, SELECTED COUNTRY GROUPS AND CHINA, 1980–2013

(Per cent of GNI)



Source: UNCTAD secretariat calculations, based on *UNCTADstat*; and World Bank, *World Development Indicators* database.
Note: Regional aggregates refer to the same countries as in chart 5.1, except for Ethiopia, the Russian Federation and Yemen, for which data were not available. The chart shows total external debt to be larger than the sum of public and private debtors, because external debt is not always fully disaggregated by public and private debtors.

External private debt, on the other hand, was historically quite limited. Thus it attracted little attention from oversight bodies. Moreover, those bodies tended to be influenced by free market advocates, who opposed government intervention in growing private external liabilities on the grounds that such liabilities resulted from the actions of so-called "rational agents" with respect to private saving and investment decisions, and therefore would not lead to financial distress. However, experience, particularly in the aftermath of the global financial crisis, when high external private debt became a main driver of public sector debt crises, has challenged the validity of such an argument.[4]

Policymakers should therefore not be too complacent about the overall lower levels of public debt in many developing economies; rather, they should be wary of the significant risks to financial stability associated with the increasing ratios of private external debt to GNI (chart 5.4). This includes rising levels of private external borrowing by non-financial corporations, primarily for purposes of financial operations via the offshore issuance of debt securities over the past few years (Avdjiev et al., 2014). This is compounded by exchange-rate risks and the danger of sudden reversals of capital flows, for example in the wake of a normalization of United States interest rates, and/or volatile commodity prices. Hence, a rapid expansion of private external debt could be followed by debt crises and a rapid increase of public external debts. Indeed, following the Latin American debt crisis in the 1980s, a large share of the external debt owed by the private sector was transferred to the public sector. Similarly, during the build-up to the Asian financial crisis of 1997, a significant proportion of the debt incurred in the region was in the form of bank loans to private borrowers that were de facto nationalized after the onset of the crisis.

The structure of external debt has also evolved significantly on the creditors' side. In most developing countries, until the 1970s, and sometimes in subsequent decades, a large proportion of long-term external debt was owed to official creditors mostly on a bilateral basis. This was the case, in particular, for developing countries whose economic links with their former metropolitan centres had remained strong and for the less developed countries to which commercial banks were reluctant to lend. In the early 1970s, in all developing regions other than Latin America, external debt owed to official creditors outpaced that owed to private creditors. In the period 1970−1972, 67 per cent of African external debt was owed to bilateral or multilateral official creditors; in West Asia this share was 92 per cent, climbing to 93 per cent in South Asia. By contrast, 70 per cent of Latin American debt and almost half that of South-East Asia was contracted with private creditors (chart 5.5). In recent years, the share of official debt in developing and emerging economies has remained below 20 per cent of the total external debt.

Throughout the 1970s, developing countries' external debt rose sharply (mainly on account of Latin American borrowers). Their total long-term external debt increased from about 13 per cent of their combined GNI in 1970 to 21 per cent in 1980, due primarily to a surge in their debt owed to private creditors, from 6 per cent to 13 per cent of their GNI. Capital account liberalization and commercial banks' efforts to "recycle" petrodollars played an important role in this development. It was further facilitated by legislation in developed economies to strengthen and clarify creditors' rights in case of foreign sovereign defaults, such as the United States Foreign Sovereign Immunities Act of 1976 and the State Immunity Act 1978 of the United Kingdom (Bulow and Rogoff, 1990).

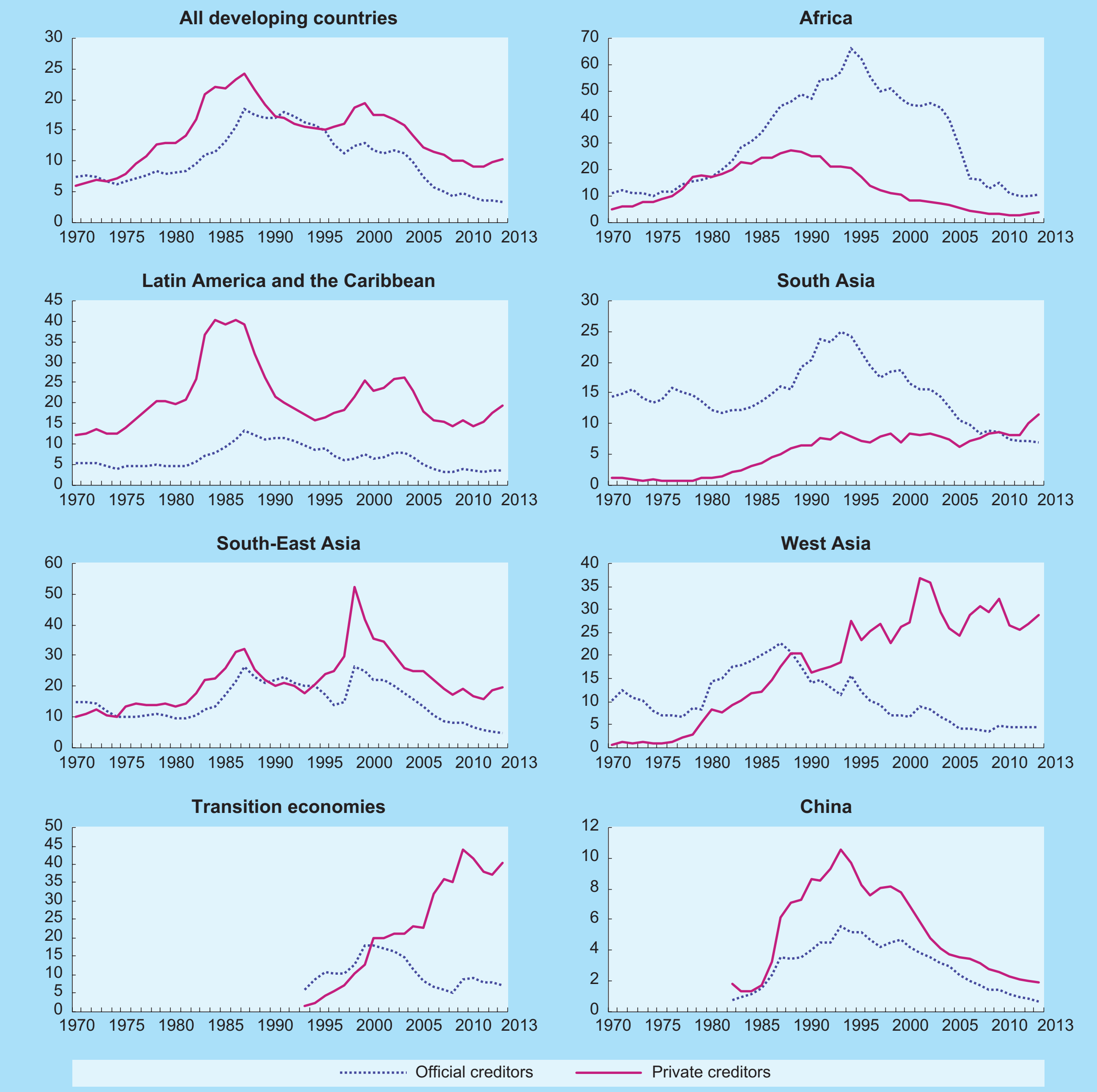
While the Federal Reserve interest-rate shock in the United States and subsequent debt crises in developing countries virtually stopped new private capital flows to these economies, private debt kept increasing as a percentage of GNI until 1987 due to low (or negative) output growth and sharp devaluations in the crisis-hit economies. Official debt – both bilateral and multilateral – as a share of their GNI also rose rapidly, mostly due to the interventions of official creditors to avoid massive defaults. As a result, between 1979 and 1987, developing countries' external debt owed to official bilateral and multilateral creditors increased from 8 to 19 per cent of their GNI.

After 1987, the stock of debt owed by borrowers in developing countries to private creditors declined from its peak of 24 per cent of their GNI in 1987 to 9 per cent in 2011. This overall decline was punctuated by a number of boom and bust episodes in several large developing economies, which led to new financial crises and were reflected in temporary but sharp increases in the external debt owed to the private sector (reaching 19 per cent of developing countries' GNI in the late 1990s). External debt owed

Chart 5.5

LONG-TERM EXTERNAL DEBT BY TYPE OF CREDITOR, SELECTED COUNTRY GROUPS AND CHINA, 1970–2013

(Per cent of GNI)



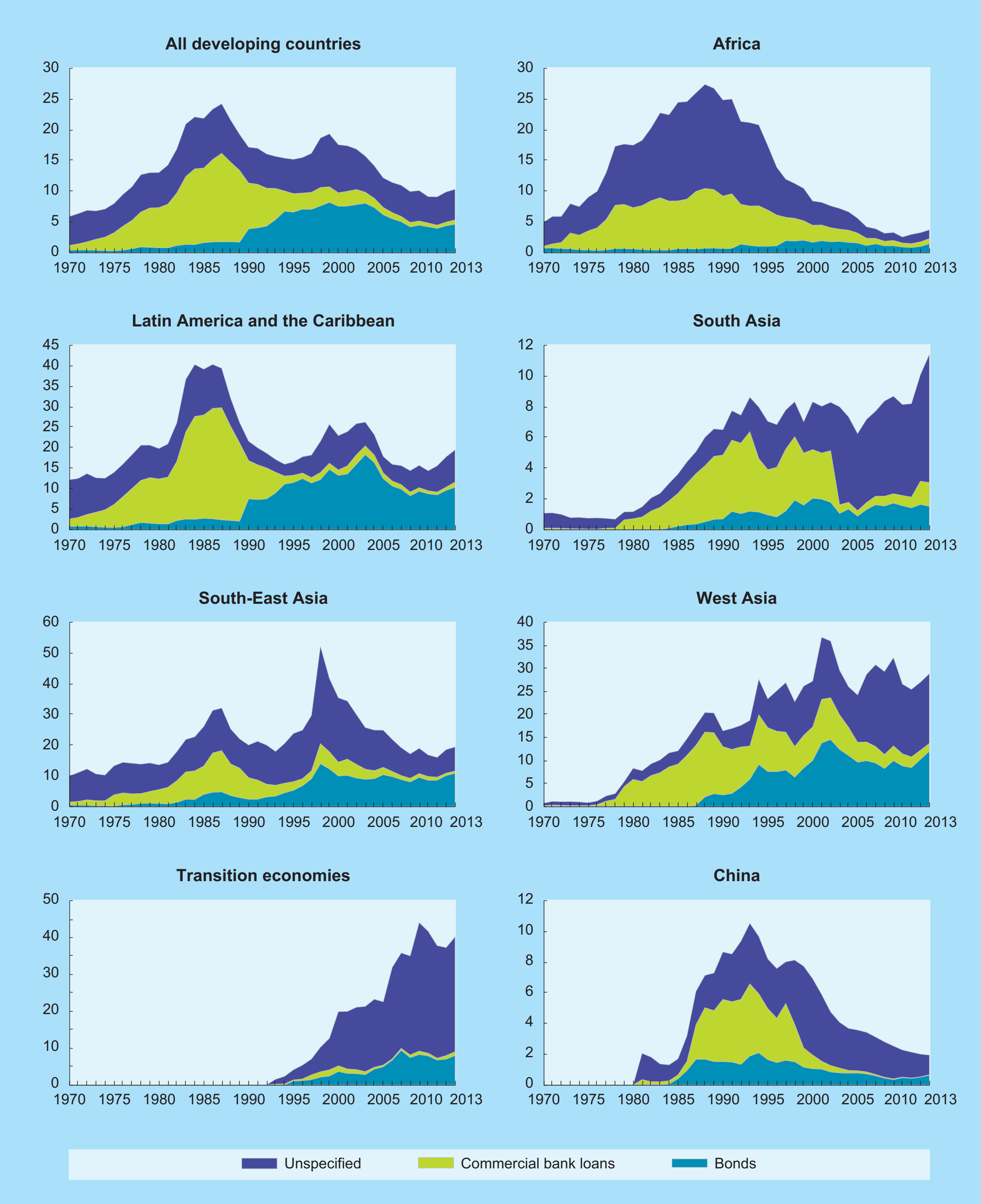
Source: UNCTAD secretariat calculations, based on *UNCTADstat*; and World Bank, *International Debt Statistics* database.

Note: Aggregates are based on countries for which a full set of data were available since 1980 (except for the transition economies where the cut-off date was 1993). Africa comprises Algeria, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, the Congo, Côte d'Ivoire, the Democratic Republic of the Congo, Djibouti, Egypt, Gabon, the Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mauritius, Morocco, Niger, Nigeria, Rwanda, Senegal, Seychelles, Sierra Leone, Sudan, Togo, Tunisia, Uganda, Zambia and Zimbabwe. Latin America and the Caribbean comprises Argentina, Belize, Bolivia (Plurinational State of), Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Panama, Peru, Saint Vincent and the Grenadines, and Venezuela (Bolivarian Republic of). South-East Asia comprises Indonesia, Malaysia, the Philippines and Thailand. South Asia comprises Bangladesh, India, Nepal, Pakistan and Sri Lanka. West Asia comprises Jordan, Lebanon and Turkey. Transition economies comprise Albania, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, Tajikistan, the former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine and Uzbekistan. Data refer to all disbursed and outstanding debt at year-end.

Chart 5.6

LONG-TERM EXTERNAL DEBT OWED TO PRIVATE CREDITORS, BY TYPE OF DEBT, SELECTED COUNTRY GROUPS AND CHINA, 1970–2013

(Per cent of GNI)



Source: See chart 5.5.
Note: See chart 5.5.

to official creditors declined more steadily, due partly to debt relief for the poorer countries, and partly to the deliberate policy by middle-income countries of limiting their recourse to multilateral financing.

The accumulation of quasi-accepted arrears on debt service – including the IMF's policy of "lending into arrears" – plus the fact that large private banks in the financial centres had become solid enough to be able to sustain selling their portfolio of loans at a discount, led the Government of the United States to adopt the 1989 Brady Plan. This was an implicit recognition that troubled debtors could not fully service their debts and restore growth at the same time, thus paving the way for negotiations between the creditor banks and debtor nations to shift the primary focus from debt rescheduling to debt relief. Most Brady restructurings included the exchange of bank loans for bonds, of either equal face value but with a fixed and below-market rate of interest, or a lesser face value. The plan thus initiated a process of "financial disintermediation", that is, of more direct borrowing from the capital markets via bonds instead of borrowing from commercial banks. This has been on an accelerating trend ever since (chart 5.6). While this change in financing instruments has rendered developing countries' debt more liquid, it has also resulted in more complex debt renegotiations with a myriad of bondholders, in addition to increasing developing countries' exposure to higher risk external debt.

3. Currency-related issues

The currency in which external debt is denominated significantly affects debt sustainability. Debt denominated in foreign currency is more risky than one denominated in domestic currency, because in case of currency devaluation, the burden of the former kind of debt in domestic currency terms would immediately increase, sometimes very significantly. More generally, even without devaluation, debtors would only be able to repay their external debt if they generated enough revenue (and, in the case of governments, if they realized a large enough primary budget surplus) and if the economy as a whole achieved a trade surplus. However, it may be difficult to meet both conditions simultaneously. Higher private and public revenues require output growth that generally is not possible without expanding imports, but this affects the ability to generate a trade surplus. Conversely, deflationary adjustment with a decline in imports as a way to rapidly achieve a trade surplus makes it very difficult to achieve fiscal primary surpluses, and private debtors may become insolvent. This trade-off between trade and fiscal balances is another factor that explains why sovereign debt denominated in foreign currency tends to be less sustainable than that denominated in domestic currency.

Importantly, debtors facing solvency or liquidity problems vis-à-vis foreign currency liabilities cannot rely on the support of a domestic lender of last resort (e.g. national central banks); and even solvent debtors may be forced to suspend their debt repayments if they are unable to obtain enough hard currency due to balance-of-payments restrictions that are beyond their control. By contrast, debt in local currency reduces the risk of a currency mismatch between debt, on the one hand, and assets and revenues on the other, and the exchange-rate risk rests with the creditors. Moreover, with this kind of debt it is possible for the national central bank to step in when an emergency situation arises.

Consequently, a growing number of developing economies have been shifting towards local-currency-denominated debt. Nevertheless, the drawbacks of foreign-currency-denominated debt remain a relevant issue for them as well, since a large proportion of their gross external debt is still in the form of bank loans and official debt, and is thus denominated in foreign currency. This is particularly the case in poorer developing countries with small domestic debt markets, a heavy dependence on official lending and low credit ratings, but also in some larger middle-income developing countries and transition economies. For instance, in 2013, the share of external debt denominated in foreign currency, was 95 per cent in Argentina, 93 per cent in Turkey, 80 per cent in India, 74 per cent in the Russian Federation, 70 per cent in the Republic of Korea and 64 per cent in Mexico.[5] Among the developing and emerging market economies that are members of the G20 (and for which data are available), only South Africa had a larger share of external debt denominated in domestic rather than foreign currency (i.e. 55 per cent of its gross external debt position). Even though these figures represent relatively low percentages of GNI, the risk remains that external debt could grow significantly in the event of domestic currency depreciations.

As a result of the considerable advantages associated with debt in domestic currency, developed countries whose currency is accepted in international payments and for constituting international reserves, and which have the possibility of issuing bonds and loans in their own currency, tend to incur larger amounts of external debt, including in difficult times. For instance, between 2003 and 2013, the gross external debt of the United States increased from 60 per cent of GNI to almost 100 per cent. Between 2001−2003 and 2013, this ratio rose from 31 to 55 per cent in Japan, from 113 per cent to 144 per cent in Germany and from 114 per cent to 194 per cent in France. Last but not least, in the United Kingdom, it rose from 198 per cent in 1999 to 354 per cent in 2013.[6] An important counterpart to these significant increases in external debt in developed countries is the accumulation of foreign reserve holdings in many developing countries since the late 1990s. This creates an avenue for some of these countries – particularly those running a current account deficit – to accumulate debt at a low cost.

4. The jurisdiction for debt issuance

The jurisdiction under which a debt contract is issued is relevant in case of a default, because it defines the courts and the legislation under which the process of debt restructuring is ultimately decided. Schumacher et al. (2014) note that in recent years, almost 50 per cent of sovereign defaults involved legal disputes abroad, compared with just 5 per cent in the 1980s; and 75 per cent of these litigations involved distressed debt funds, also known as "vulture funds".

Formerly, there was a close match between the place of issuance, the jurisdiction for the debt, the residence of the ultimate holder and, to a lesser extent, the currency denomination of the debt. However, some recent indications suggest that more and more international investors are entering domestic debt markets of developing countries, and that domestic investors often hold bonds issued in international markets (Panizza, 2008). Such information, which is critical for identifying external debt through the residence of the creditor, is sometimes difficult to obtain.

Looking at all the outstanding public bonds (irrespective of the residence of the creditors and the currency of denomination), recent data show that the majority of these have been issued in domestic markets. In some developing subregions, such as East and South Asia, the percentage of domestic public bond issuance has been as high as the average for developed economies. In the transition economies, in Latin America and the Caribbean, and in West Asia, 28, 28 and 32 per cent, respectively, of outstanding public bonds at the beginning of May 2015 were issued in foreign markets (and normally under foreign jurisdictions).[7] This leaves room for vulture funds to pursue holdout litigations in foreign jurisdictions in future debt restructurings.

D. External debt resolution

Given the frequent occurrence and continuing vulnerability of the globalized and financialized economy to debt crises, national and international policymakers require more appropriate instruments to handle such crises in a way that will minimize their costs. In principle, debt resolution mechanisms should help prevent the threat of financial or debt crises when countries experience difficulties in meeting their external obligations, pre-empting the kind of sudden collapse of market confidence which can have catastrophic long-term consequences for the debtor economy. But debt resolution mechanisms should also aim at a fair distribution of the burden of debt restructurings between debtors and creditors once a crisis does erupt. Finally, they should respect national sovereignty and preserve domestic policy space with a view to enabling a debtor economy to grow, achieve improved debt sustainability and design and implement its own development strategies. This section summarizes the main characteristics of external debt crises, followed by an analysis of the historical evolution of sovereign debt problems, and, in particular, approaches to resolving them.

1. External debt crises: A recurrent problem

While the structural causes of developing countries' debt crises vary, recent crises have been closely linked to the rapid liberalization of financial markets, their inherent instabilities and the "global financial cycles" these have produced (UNCTAD, 2014). Generally, debt crises occur at specific junctures in financial cycles. They start when a significant number of debtors (or some large ones) are no longer able to service debt accumulated during an expansionary phase. As a result, risk perception shifts from overconfidence to extreme unease, leading to liquidity shortages, asset price collapses and an economic downturn. Eventual asset liquidations further depress asset prices, in particular prices of those assets that were the primary object of speculation during the boom period and served as a guarantee for the debt. This not only causes the bankruptcy of highly indebted agents, but also affects more prudent agents who would be solvent in normal times. Once a debt crisis occurs, a potentially long process of financial consolidation must take place before the economy can begin to recover, lending can resume and an eventual exit from the crisis can be achieved.

Recent external debt crises have been closely linked to the rapid liberalization of financial markets and to the global financial cycles they produce.

The specificities of external debt, discussed in the preceding sections of this chapter, tend to increase the vulnerabilities associated with financial cycles. The greater openness of many developing economies to poorly regulated international financial markets is largely responsible for the build-up of their external debt and their concomitant exposure to high risks of macroeconomic instability. In theory, openness to capital flows can have a countercyclical effect by allowing developing countries to borrow during economic slowdowns and repay during expansions. But this would require capital flows to respond passively to demand from developing countries, and for them to be used effectively for countercyclical purposes. In reality, "push" factors in the developed economies, such as their monetary policies, risk perceptions and the leverage cycles of their banks, are often the driving forces (O'Connell, 2014). Indeed, all major waves of capital flows to developing countries since the mid-1970s have been prompted by expansionary monetary policies aimed at mitigating economic recessions in the major developed countries (Akyüz, 2012). With limited credit demand and low interest rates in their own markets, financial institutions from developed countries have channelled part of their credit to developing or emerging economies in search of higher yields (*TDR 2014*). These flows have frequently exceeded the amount that most developing countries could use productively (Haldane, 2011).

Very large capital inflows entering relatively small economies have thus tended to generate domestic credit booms, strong asset price increases and currency appreciations. They have also facilitated sizeable imports of consumer goods and services, leading to current account deficits and overindebtedness, particularly in the private sector. When economic conditions and risk perception in developed countries change or indebted developing countries experience repayment difficulties, capital movements can reverse suddenly and trigger external debt crises. Steep currency depreciations increase the value of external debt in the domestic currency, resulting in insolvency for those agents whose incomes are mainly denominated in domestic currency and whose external liabilities are not matched by external assets. Widespread bankruptcies, affecting not only the real economy but also the financial sector, typically prompt central bank interventions to try to contain the crisis, including through bailouts, emergency financing and countercyclical measures. As a result, external debt crises are often also public sector crises. Even where governments themselves have not engaged in extensive foreign borrowing during the boom period, they are frequently forced to absorb bad private debts.

Private external debt defaults do not pose a specific problem in themselves: so long as the debt does not affect the wider economy in a systematic manner, managing private defaults only requires applying the private commercial law in the jurisdiction where the debt was issued. By contrast, sovereign external debt problems present particular features that, in case of a default, require specific arrangements to manage them. The systemic issues raised by sovereign debt and default, and the legal as well as economic challenges they pose, are discussed in the remaining sections of this chapter.

Even when governments have not engaged in foreign borrowing during the boom period, they are frequently forced to absorb bad private debts. Thus, external debt crises are often also public sector crises.

2. *Sovereign debt issues in historical perspective*[8]

In some respects, sovereign debtors are more vulnerable than private debtors: unlike private debtors, if they are unable to service their debt by the due date, they cannot seek the protection of bankruptcy laws for restructuring or delaying their repayments. In another respect, they are less vulnerable than private debtors, because creditors cannot seize most public assets in payment for a defaulted debt. In fact, most of these assets are located in the sovereign's jurisdiction and protected by domestic laws. Those that are located abroad benefit from sovereign immunity clauses that limit the kinds of assets a foreign tribunal can confiscate. Only assets linked to commercial activities can be seized, and not the ones related to the intrinsic role of a State, which include international reserves. As a consequence, the main way of resolving sovereign debt issues has historically been through renegotiation between debtor governments and their creditors, broadly following a private-law paradigm.

Hence, throughout the nineteenth century, debt restructurings were a bilateral matter, dealt with exclusively between the debtor and the creditor. Crisis resolution was not always swift or smooth, but mutual self-interest helped the parties to reach agreement. In general, domestic currency devaluation was not an option, since debt instruments frequently included gold clauses, which obliged the debtor State to make payments in gold, or the equivalent thereof. Creditors, on the other hand, were in a weak bargaining position at a time when the respect for sovereign immunity was stronger than it is today, and they lacked an effective means to coordinate their claims. Even after the formation of support structures, such as the Corporation of Foreign Bondholders (in the United Kingdom), and later the Foreign Bondholders' Protective Council, they frequently lacked government support (Eichengreen and Portes, 1986; Feldmann, 1991; Adamson, 2002). Moreover, legal enforcement was virtually impossible for them, since sovereign immunities were more strictly observed than they are today, and effectively protected States against such enforcement, if not against legal proceedings. International arbitration was rare, in general, and even more so for sovereign debt, while military intervention and gunboat diplomacy remained the exception.[9] Debt restructurings thus followed a private-law paradigm, characterized by horizontal dialogues between relatively equal parties, and they did not require the intervention of international institutions representing some wider public interest.

This changed after the First World War, when sovereign debt issues acquired a new dynamic in the context of German defaults on reparation payments, the wider economic impact of the First World War on other economies and, more generally, the detrimental effects of an increasingly fragile international monetary system. Multilateral efforts to prevent sovereign debt crises, and to solve these where they had already occurred, played an important role throughout this period in elevating debt sustainability and resolution to the level of an international concern, and in raising international awareness of the public interests at stake in sovereign debt negotiations. The United States took the lead in designing ways to settle Germany's First World War reparation debt without risking the latter's total economic collapse and political disintegration, through the 1924 Dawes Plan and its successor, the 1929 Young Plan. Other multilateral attempts to deal with sovereign debt problems were made by the League of Nations. The League did not have funds to provide financial support for troubled debtor States, but it scrutinized the development of contractual provisions used for sovereign bonds, advised member States on economic reform, and monitored the implementation of its recommendations with the aim of helping indebted States regain access to capital markets (Myers, 1945; Florez and Decorzant, 2012). It even established a Committee for International Loan Contracts, which systematically investigated sovereign debt issues between 1935 and 1939. At the same time, the Permanent Court of International Justice helped French creditors to enforce contractual rights to repayment in gold by Brazil and Serbia (Waibel, 2011). Overall, and while sovereign debt restructurings largely maintained their consensual and horizontal structure of negotiations between debtor States and creditors' committees, the need for debtor States to quickly return to capital markets seems to have been generally recognized, not least in the wake of the Great Depression and the many sovereign defaults this entailed (Lindert and Morton, 1989; Feldmann, 1991; Reinhart and Rogoff, 2009).

With the emergence of the Bretton Woods System after the Second World War, a new international economic order emerged, which had a greater capacity to deal with sovereign debt problems, although these became much less frequent throughout the Bretton Woods period. While some countries, such as the United Kingdom and the United States, reflated their way out of their mostly domestic debt (Grossman 1988),[10] other debt restructurings became a concern for international law. Most famously, the 1953 London Agreement (see box 5.1) to restructure the German external debt − both official and private − from the interwar period underlined the importance of substantial debt relief, not only for the economic prosperity of the debtor country and its economic partners, but also for global political stability and peace.

For developing and emerging economies requiring a restructuring of their bilateral official debt, the Paris Club has provided a fairly comprehensive forum for negotiations since the mid-1950s (Cosio-Pascal, 2008). However, over many years, the restructurings achieved through this institution seemed to give precedence to repayments to creditors rather than to debt relief (Eskridge, 1985).

Thus, on the whole, the private-law paradigm still prevailed, although a global public concern for debt sustainability was now more recognizable than at the turn of the century. Within this framework, the bargaining power of debtors and creditors shifted in favour of the latter. Laws such as the United States Foreign Sovereign Immunities Act of 1976, the United Kingdom State Immunity Act of 1978 and other similar acts passed by most countries in Western Europe ended the concept of absolute sovereign immunity. This meant that a government whose activities were considered to be "commercial" and not intrinsic to the State was not entitled to claim sovereign immunity and could be subject to litigation in foreign courts.[11] These changes became particularly relevant with the return of sovereign debt crises in the early 1980s, after almost 30 crisis-free years (Reinhart and Rogoff, 2009).

Since the 1970s, the bargaining power in debt restructuring has shifted in favour of the creditors, both private and official.

3. *Emergence of a fragmented resolution system for external sovereign debt*

The 1989 Brady Plan was based on recognition that a sustainable solution to debt overhang in developing countries would require debt restructuring and relief. To this end, it initiated a shift from syndicated bank loans to disintermediated bond financing of external debt.

By the end of the 1980s, renewed concerns on debt sustainability also led the Paris Club (see below) to incorporate special treatment for the debt of poor countries owed to official creditors. The "Toronto terms" approved in 1988 granted, for the first time, debt relief of up to 33 per cent of non-ODA credit received by poor countries. The levels of debt cancellation were subsequently increased with the "London terms" in 1991, the "Naples terms" in 1994 and the "Cologne terms" in 1999, to 50, 67 and 90 per cent,

Box 5.1

THE LONDON AGREEMENT ON GERMAN EXTERNAL DEBT

The London Agreement between the Federal Republic of Germany (FRG) and its then creditors, concluded in London on 27 February 1953, was a debt relief agreement. It was indispensable for the rebuilding of the West German economy soon after the Second World War, and was a major factor contributing to that country's so-called "post-war economic miracle".

The agreement covered both the pre- and post-Second World War German debt. Just over 20 billion deutsche mark of this debt, including interest, stemmed from loans taken prior to 1939 to pay reparations agreed after the First World War; the remainder of just over 16 billion deutsche mark represented United States reconstruction loans after the Second World War. While the negotiations took place only with the FRG, they covered the entire German debt with Western debtors that the FRG had inherited in full after the end of the Second World War. Under the London Agreement, West German debt was cut by just over 60 per cent (including interest payments) to 14.5 billion deutsche mark.

The London Agreement needs to be understood in the context of the wider United States policy concerning West European reconstruction after 1945. Already in October 1950, the Western Allies signed a declaration on the German debt problem in which "the three countries agree that the plan include an appropriate satisfaction of demands towards Germany so that its implementation does not jeopardize the financial situation of the German economy through unwanted repercussions nor has an excessive effect on its potential currency reserves. The first three countries are convinced that the German federal Government shares their view and that the restoration of German solvability includes an adequate solution for the German debt which takes Germany's economic problems into account and makes sure that negotiations are fair to all participants" (cited in Toussaint, 2006). Substantial debt cancellation for West Germany ranked high in the Western Allies' priorities for post-war reconstruction as a means to ensure the country's future economic and political stability and its firm integration into the emerging bloc of anti-Soviet Cold War allies. Beyond these political considerations, the economic logic underlying the agreement is in sharp contrast to the austerity conditionalities that characterize contemporary approaches to debt restructuring, such as for Greece. Apart from debt cancellation per se, this is evident in the specific measures and arrangements included in the London Agreement:

- *Debt servicing and trade:* The agreement limited the amount of export revenues that the FRG could spend on debt servicing to 5 per cent of the total in any one year. This is markedly lower than the percentages allowed for developing-country debt servicing since the 1980s, which have ranged between 8 and 20 per cent of export revenues. In addition, debt payment was linked to trade surpluses, and could be postponed if the country ran a trade deficit, so that there was no need for it to resort to new sources of borrowing, thus avoiding the creation of a potentially vicious circle of debt accumulation. At the same time, this also ensured that it was in the creditor nations' interests to increase their demand for German exports.
- *Interest rates and currency denomination*: Interest rates on the FRG's debt ranged between 0 and 3 per cent, again substantially lower than average interest rates on debt incurred by today's developing countries. Importantly, the debt could be paid in deutsche mark rather than in any creditor currency, thus freeing that country from the need to use its foreign export earnings for debt repayments.
- *Comprehensiveness of debt restructuring*: The London Agreement brought together the vast majority of the FRG's creditors around a single table, including official and private creditors. This ensured equal treatment of creditors as well as swift decision-making that provided a clear, comprehensive and long-term plan for debt repayment. There was no possibility for private creditors to opt out of the arrangement with a view to speculating on German debt and obliging the country to engage in long processes of renegotiation and litigation.
- *Renegotiation option*: The London Agreement explicitly included the option for the FRG to suspend debt servicing and seek renegotiated terms in the event of any substantial changes to its situation.

The agreement was thus clearly informed by an economic rationale based on the view that safeguarding and promoting the future growth potential of the debtor economy was essential for enabling it to service its debt. Expansionary economic policies, actively supported by the creditors, were the precondition for debt repayment. Given the FRG's remarkable success with post-war reconstruction, arguably the London Agreement provides a constructive template for today's creditors, both private and official.

respectively.[12] The Paris Club also extended the possibility of debt relief to non-HIPC developing countries, on a case-by-case basis, under the "Evian terms" in 2003 (Paris Club, 2015).

Furthermore, regarding the multilateral official debt of poor countries, in 1996 the IMF and the World Bank launched the Heavily Indebted Poor Countries (HIPC) initiative, which was enhanced in 1999. Under this initiative, poor countries that bore a very high debt burden were offered multilateral debt relief and access to credit on concessional terms. In addition, the IMF progressively liberalized its lending practices by introducing a "lending into arrears" policy for States that were in arrears on payments to their private creditors, provided they were involved in bona fide negotiations with their creditors. Hence, specific tools were gradually introduced to handle sovereign external debt distress with bilateral or multilateral creditors, and involved case-by-case negotiations between official counterparts.

By contrast, the series of emerging market crises, which began in Mexico in 1994, elicited traditional policy responses from these same institutions. Their new lending was conditional on the recipient's commitments to austerity, the adoption of "appropriate" macroeconomic policies and structural reforms. Since these official credits were used largely to prevent countries defaulting on their debts to private creditors, they did not mitigate the countries' economic slowdown or diminish their debt burden; rather, they appeared to be rescuing the creditors. The high cost of these policy responses in terms of lost output and excessive constraints on national policy space generated widespread dissatisfaction with sovereign debt resolution mechanisms, leading the IMF to propose the creation of a sovereign debt resolution mechanism (SDRM) for debt held by private investors. Following the failure of this initiative – which was rejected not only by private creditors, but also by the Governments of the United States and some emerging market economies – private external debt issues have remained the prerogative of commercial courts and direct debtor-creditor negotiations.

The current fragmented sovereign debt resolution system applies different procedures to handling diverse kinds of external sovereign debt.

These developments have given rise to a fragmented sovereign debt resolution system, with different procedures for handling diverse kinds of external sovereign debt (bilateral and multilateral debt, bank loans and external bonds) when difficulties arise (UNCTAD, 2015). The Paris Club provides the main negotiating forum for restructuring the *official bilateral debt* of its creditor member States. This group is comprised of 19 developed countries that are the major providers of official credit to developing countries. Negotiations, which cover medium- and long-term debt, including export credits whose terms exceed one year, normally take place after the debtor government has agreed to an IMF loan and its associated conditionality, although a few exceptions have been accepted recently. Negotiations result in "agreed minutes" which include the general terms of debt restructuring. This is followed by bilateral agreements with each participating government that may present some differences, as long as they follow the general guidelines. The Paris Club has sought to establish a framework for debt restructuring by seeking "comparability of treatment", whereby the debtor government commits to seeking similar treatment from other official creditors that are not members of the Paris Club, and also from foreign private creditors.[13] Domestic debt and multilateral debt are excluded from this requirement.

Multilateral institutions play a key role in sovereign debt resolution, despite the fact that *multilateral debts* have generally been exempted from debt restructuring or relief. The involvement of the IMF, the World Bank and multilateral development banks typically consists of providing exceptional financing when voluntary private sources dry up or are no longer available. In compensation, these institutions have benefited from the status of preferred creditor. Their financing has generally been conditional upon strict and comprehensive policy requirements, originally intended to ensure that countries would be able to correct their imbalances and repay their loans.[14] Therefore, securing a credit agreement with these institutions (and particularly with the IMF) has been a precondition for negotiating debt restructuring or relief with other creditors, as the associated conditionality has been viewed as a commitment from the debtor country to address the causes of its debt problems.

The main exception to the rule that exempts multilateral debt from restructuring or a haircut is the debt owed by poor countries, mainly through the HIPC Initiative launched in 1996, broadened in 1999, and deepened through the Multilateral Debt Relief Initiative (MDRI) in 2005. The original HIPC Initiative was aimed at providing the poorest countries with an exit from the repeated debt rescheduling process. It was designed to coordinate the efforts of involved creditors through broad and equitable participation, most prominently by multilateral institutions and Paris Club official creditors, but also by non-Paris Club bilateral official creditors and commercial lenders.[15] Subsequent iterations that have extended relief in various ways, have been linked to country performance. They have also developed a more systematic approach to the quantitative evaluation of debt sustainability through the formulation of threshold values for standard debt indicators based on historical experience, and the inclusion of an adjustment for external shocks. Subsequent efforts to refine this evaluation methodology have been tried, but continue to be dogged by criticism about the lack of transparency in the underlying assumptions of what constitute "good" or "bad" policies and the institutional arrangements, as well as persistent problems in differentiating effectively between liquidity and solvency characteristics of impending debt crises (Ocampo et al., 2007).

Hence, overall debt restructuring with official creditors follows a pre-established procedure with little room for negotiation. This contrasts with the treatment of sovereign debt with private creditors, which consists of bank loans and external bonds. *Bank loans* are subject to negotiations at the London Club, an informal group of international commercial banks established in 1976. When a sovereign debtor requests debt restructuring, a bank advisory committee (BAC) is created within the London Club process and chaired by a lead bank − generally the one with the largest exposure – whose main task is to coordinate the creditors' bargaining position. The BAC eventually reaches an agreement with the debtor government and seeks to convince all the bank creditors (even those that are not members of the BAC) to sign on. Since the London Club does not establish binding resolutions or have defined voting procedures, agreements have sometimes required long negotiations, and free-riders have posed a recurrent problem. Although the negotiation process allows considerable flexibility within the private-law paradigm, it has maintained some links with negotiations on official bilateral and multilateral debt. For instance, reaching a credit agreement with the IMF is a de facto requirement for a government that is seeking to restructure its debt with the London Club, and reciprocally, avoiding arrears in payments with private banks is a usual condition for signing an agreement with the IMF. Regarding Paris Club agreements, commercial banks are normally asked to offer "comparable treatment" (i.e. debt relief) to that offered by official creditors. This latter approach has repeatedly been criticized for its lack of transparency about the underlying methodology for determining comparability as well as for its lack of enforceability (UNCTAD, 2015).

The substantial shift from syndicated bank loans to external bond financing over the past two decades has significantly increased the complexity of debt restructuring.

The substantial shift from syndicated bank loans to *external bond* financing over the past two decades has significantly increased the complexity of debt restructuring. Thousands of bondholders with diverse interests can face divergent regulatory constraints, and bond series can be issued in different jurisdictions. Usually, an informal negotiation takes place in committees where different groups of bondholders are represented.[16] The debtor country eventually proposes bond swaps with lower face values, longer maturities and/or lower interest rates. Other basic characteristics of the bonds may also be altered: new bonds may be denominated in a different currency, be subject to a different jurisdiction, and incorporate new clauses, such as collective action clauses (CACs). Bondholders then vote for or against accepting the swaps. If the old bonds included CACs, a qualified majority may make the vote binding on all bondholders. If no such CACs are included, or the required majority is not obtained through voting, creditors that have not accepted the swap ("holdout bondholders" or "holdouts") may seek better terms or even full repayment through litigation.

Debtors can try to obtain wider acceptance of their proposal by promoting "exit consents", through which bondholders who accept the swap are asked to vote to alter the non-repayment terms of old bonds to make them less liquid and attractive to holdouts. They can also establish minimum participation thresholds, meaning that their restructuring offer only holds if a minimum number of bondholders accept it. In this case, creditors wishing to end a moratorium and start receiving a payment may try to convince other creditors to accept the deal. However, many bondholders may also prefer to sell their bonds at a discount in the secondary market rather than wait for the conclusion of the negotiation process. Increasingly, conventional bondholders are being replaced by specialized investors not interested in reaching a settlement, but seeking to obtain full payment through litigation (including the so-called "vulture funds"). As discussed further below, this has become the most serious challenge for debt restructuring.

> The present scheme of debt resolution has tended to delay the swift and comprehensive action needed to prevent a debt crisis from spiralling out of control.

4. *An inefficient and unbalanced approach to debt resolution*

(a) *Too little, too late*

An early diagnosis that determines, in particular, whether a country is facing a liquidity or solvency crisis is essential for the orderly management of a debt problem. The present fragmented scheme has proved inefficient in providing such early diagnoses, and has tended to delay often urgently required swift and comprehensive action to prevent a debt crisis from spiralling out of control.

It appears, under the current system, that neither debtor governments nor creditors have an incentive to recognize a situation of overindebtedness and take early and comprehensive action (Buchheit et al., 2013). For debtor governments, a major disincentive is the likelihood that declaring a debt moratorium will have a self-fulfilling effect by triggering an economic crisis. Furthermore, defaulting "too early" may be viewed by creditors as a strategic (avoidable) default aimed at lowering debt servicing costs. Governments may want to avoid the consequent reputational costs − which would result in lower access to credit − that may outweigh the benefits. Therefore, they may postpone a needed default until it becomes clearly "unavoidable" so as not to raise doubts about their good faith and willingness to pay. Finally, governments quite frequently fail to fully perceive the increasing risks, and only react when crises have already started.

Creditors also have an interest in delaying explicit recognition of a solvency crisis, as opposed to a mere liquidity crisis, since, in case of a solvency problem, no creditors can expect to recover their loans in full (except, to some extent, multilateral institutions with preferred creditor status). Private lenders therefore tend to initially minimize the extent of the debt problems. This can receive official endorsement from an initial diagnosis by the IMF which agrees emergency support (as has happened in all the major debt crises since the 1980s), and forecasts a rapid recovery following the implementation of adjustment policies. Those forecasts in general have been too optimistic (IMF, 2003b; *TDR 2011*, chap. III), but have provided the rationale for the "liquidity problem" hypothesis. As a consequence, debtor governments have received credit from official sources, while private creditors have been reluctant to renew credit lines and have opted for immediate repayment. One implication has been the so-called "revolving door" process, with official credit funds being used to repay debts to private agents, instead of supporting the real economy and helping to restore growth. Precisely to avoid such inefficient use of exceptional financing, the IMF's Articles of Agreement include a rule to

> Since solvency crises were treated as liquidity crises, official credit extended to indebted governments was used to repay debt to private agents, instead of helping to restore growth.

the effect that "a member may not use the Fund's general resources to meet a large or sustained outflow of capital"(Article VI). Since the 1980s, this rule has been overlooked repeatedly in the managing of sovereign debt crises.

(b) *Asymmetric and procyclical resolution processes*

Unlike private firms, indebted States cannot go bankrupt. Ultimately, debt resolution processes need to focus on a debtor economy's ability to recover as quickly as possible and on minimizing social, political and economic adjustment costs. This requires a supportive international framework that allows the debtor country to conduct countercyclical policies which will enable it to restore its debt servicing capacity through investment, output and export growth, rather than import contraction. National policy should also ensure that government debt can be reduced by increasing public revenue rather than reducing expenditure.

> Debt resolution processes should focus on economic recovery and on minimizing adjustment costs. …

The current international financial and monetary system is lacking in this regard, and is characterized by a contractionary bias. This is evidenced by the IMF's "stand-by agreements" (SBAs) under which standard associated credits typically include the requirement for fiscal and monetary austerity measures based on the "absorption approach". Such an approach is based on the view that current account deficits and the resulting external debt result from a level of "absorption" (i.e. domestic consumption and investment) in excess of total output (Mussa and Savastano, 1999).

A new form of conditionality imposed by subsequent IMF lending programmes, in addition to conventional macroeconomic adjustments, is the requirement for structural reforms. In their various manifestations, these have continued to focus on contractionary measures, as well as on a general roll-back of State intervention in economic and financial areas through far-reaching liberalization and privatization policies. Besides macroeconomic adjustment and structural reforms, a third core component of the IMF-supported programmes has been to secure a sustainable flow of foreign financing. Consequently, these programmes usually also include the requirement for the recipient economy to remain current on government debt service and to eliminate any debt arrears accumulated prior to programme approval. Hence, rather than involving private creditors in a debt restructuring process, the IMF has included the servicing of private debt among its usual conditions.

Arguably, such conditionalities have done little, if anything, to promote debt sustainability through growth, and have mostly been counterproductive. The IMF has progressively acknowledged mistakes in its policy conditionalities under crisis conditions. It now argues that fiscal austerity during recessions is more costly than was previously assumed, because fiscal multipliers are higher, the assumption of a trade-off between public and private demand is questionable, and public spending cuts are not automatically offset by higher private demand (IMF, 2012). It has also recognized that its strict conditionality and a cumbersome process for delivering credit support were inappropriate for preventing or addressing external debt crises triggered by gyrations in the capital account. Consequently, it has created new credit lines with lower conditionality that would provide a "precautionary line of defense" for members that might suffer from contagion effects (IMF, 1997 and 2004; Ocampo, 2015).[17] However, so far its new credit lines have not been used much,[18] and do not address the needs of the most vulnerable countries, including those hit by an external debt crisis (*TDR 2001*).

(c) *The rise of non-cooperative creditor litigation*

The rapid rise of bond financing in external debt markets following the Brady Plan was widely expected to stabilize external debt through market discipline, coupled with sufficient legal guarantees for creditors. Thus, for instance, enforcement clauses containing a waiver of sovereign immunity were included in bond contracts. As mentioned earlier (see subsection D.2) under a number of jurisdictions, sovereigns could no longer claim immunity for what was deemed to be commercial activity. In addition, in 2004 the New York Legislature opened new opportunities for the so-called "vulture funds" when it greatly restricted the scope of the Champerty Doctrine which forbids purchasing a debt with the sole purpose of future litigation.[19]

In this context of strengthened creditor rights, vulture funds have flourished. Their strategy consists of buying defaulted bonds at a significant discount only to aggressively sue governments thereafter for repayment of their debts at face value plus interest, arrears and litigation costs, with gains of between 300 and 2,000 per cent.[20] According to Schumacher et al. (2014), such holdout litigation has become a common and increasing practice in debt restructurings, from only about 5 per cent in the 1980s to almost 50 per cent in 2010, and the total volume of principal under litigation reached $3 billion in 2010. Between 1976 and 2010, there were about 120 lawsuits by commercial creditors (against 26 defaulting Governments) in the United States and the United Kingdom alone, the two jurisdictions where most sovereign bonds are issued. This trend has since continued, with suits being filed against Ecuador[21] and Greece, among others.[22]

Holdout litigation has been particularly disruptive in the context of multilateral debt relief efforts to reduce the external debt burden of heavily indebted poor countries.[23] In practice, such litigation has significantly eroded the limited fiscal space created by debt relief to alleviate poverty and foster economic development in these countries. At least 18 heavily indebted poor countries have been threatened with or subjected to legal actions by these commercial creditors since 1999, leading to an estimated number of more than 50 lawsuits of the kind described.[24] For example, in a case against Zambia, Donegal International, a vulture fund based in the British Virgin Islands, having bought debt instruments for $3.28 million, sued the debtor for their nominal value of $55 million. The High Court of Justice of England and Wales, with notable political and moral disapproval, ruled that the Government must pay the vulture fund $15.4 million, which represented 65 per cent of what Zambia had saved in debt relief delivered through the MDRI in 2006.[25] In reaction, the United Kingdom passed legislation preventing claims against heavily indebted poor countries that exceed the amount which a holdout creditor would have received had it accepted the restructuring.[26]

> … However, such processes are characterized by a contractionary bias through the conditionality attached to lending programmes by the IMF and other official sources.

Action by vulture funds highlights the conflict between a purely private-law paradigm that seeks to enforce contracts at any cost and the logic of public law which is supposed to take into account the wider economic and social consequences of legal actions. Courts have generally endorsed holdouts' views, even at the expense of sovereign debt sustainability and the interests not only of the debtor country, but also of bondholders willing to reach a viable agreement. The main argument is that the majority of cooperative creditors must not be allowed to modify the financial terms of other creditor contracts, unless specific contractual clauses allow this possibility. United States courts have consistently ruled that, in the absence of contractual clauses providing for majority voting, the "sanctity of contracts" prevails, so that unanimity among creditors is required to make a restructuring agreement binding on every creditor.[27] Debtor States' invocation of a state of necessity has mostly been rejected by courts around the world, be they national courts or arbitration tribunals acting within an investor-State dispute settlement mechanism (ISDS).[28]

In rare cases, courts have taken into account debt sustainability concerns. Depending on the potential global effects of the restructuring at stake, in a few cases courts in the United States have acknowledged that there can be a legitimate interest in debt restructurings on the grounds of safeguarding financial stability.[29] In other jurisdictions, courts have given broader recognition to the principle of debt sustainability, by granting immunity to debt repudiation aimed at safeguarding the basic human rights of citizens in the debtor States.[30] However, these cases have not had any wider impact, and have been overshadowed more recently by the well-known ruling in the case of *NML Capital, Ltd. et al. v. The Republic of Argentina* that has been strongly supportive of the holdouts.

This case highlights two major factors that facilitate holdout litigation and threaten debt sustainability.

The first is the so-called "forum shopping", that refers to the ability of holdout creditors to shop around for favourable judges. Thus, Argentina's creditors found sympathetic judges not only in the United States, but also at the German Constitutional Court,[31] the Supreme Court of the United Kingdom,[32] and the ICSID tribunal,[33] as well as a judge in Ghana.[34] The second factor arises from the very wide interpretation of the *pari passu* clause that is widely used in sovereign debt contracts. According to a conventional reading, its purpose is to ensure that no priority ranking is established for unsecured creditors (Buchheit and Pam, 2004). By contrast, the sitting judge in the case of *NML Capital, Ltd. et al. v. The Republic of Argentina*, following an earlier Belgian case,[35] interpreted the *pari passu* clause as an obligation by Argentina to make rateable payments to NML each time it pays its restructured bondholders.[36] More specifically, the District Court's injunctions forbid any financial intermediaries from collaborating with Argentina in paying exchange bondholders unless they are notified that the holdouts have received rateable payment.

Holdout litigation and recent rulings that forbid governments to pay the restructured debt make debt restructurings more difficult than they already are. …

This ruling threatens debt sustainability in at least three ways. First, it makes future debt restructurings much more difficult than they already are by strengthening creditors' incentives not to consent to debt restructuring agreements. Not only can creditors now expect to have more leverage to seek full repayment, but those agreeing to a debt restructuring can no longer be sure that they will actually be paid. Second, given the global scope of the many financial intermediaries involved in this case, the judgment potentially has universal reach. Third, the ruling focuses exclusively on creditors' rights and disregards any wider socio-economic implications of requesting rateable payments from the debtor country, to the extent of risking an Argentine debt default and, in any case, severely undermining its future access to external financing, and thus its growth prospects.

…Such rulings show a total disregard for the sovereignty of the debtor, for third-parties' interests and for the socio-economic impacts they might have on a debtor economy.

Beyond Argentina, holdout creditors also have complicated recent Greek debt restructurings. Normally, holdout litigation is limited to debt issued under foreign law which the debtor State cannot modify unilaterally. In 2012, under the auspices of the European Financial Stability Facility, Greece restructured $206 billion of its debt by offering bondholders new bonds with a 75 per cent haircut, lower interest rates and longer maturities. The new bonds were accepted by 97 per cent of the creditors. Bonds governed by Greek law were also subject to an ex-post legislative introduction of a CAC to facilitate restructuring of the debt portfolio. Just before the haircut took place, vulture funds bought Greek bonds issued under United Kingdom legislation that did not allow Greece to activate the CACs. A month after the completion of the haircut, the Greek Government decided to pay 435 million euros to investors who had refused to participate in the restructuring. In June and July 2013, the Greek Government made two additional and higher payments, of 790 million euros and 540 million euros, respectively, to holdout creditors.

(d) The role of contingent liabilities in sovereign debt

Finally, a brief mention is warranted of another recent and growing area of concern, namely the problem of contingent liabilities of a sovereign and their treatment in processes of debt restructuring (see Buchheit and Gulati, 2013). Contingent sovereign liabilities refer mostly to third-party debt guarantees, granted either explicitly through a formal undertaking, or implicitly through informal or semi-formal arrangements that signal to the creditor the sovereign's awareness and implicit approval of a transaction. Another, even less formally acknowledged form of contingent liability of a sovereign arises from its role as lender of last resort during debt crises. As already pointed out, given the characteristics of recent developing-country debt crises, there is a relatively high probability that, in the event of such a crisis starting in the private sector of an economy, at least part of privately owed debt will be de facto "nationalized".

Third-party debt guarantees are, almost by definition, kept off the public balance sheets precisely because they constitute liabilities that are contingent on the primary debtors' ability to service the debt. At the same time, this practice keeps the sovereign State's official debt ratios low, thus facilitating continued access to future borrowings, in particular where a sovereign already has high levels of indebtedness, at least as viewed by market participants. Preliminary evidence suggests that, since the 2008–2009 global financial crises, sovereign contingent liabilities have grown significantly, although mostly in Western Europe (Buchheit et al., 2013).

How such growing contingent liabilities might be included in sovereign debt restructurings is currently unclear, since there is hardly any relevant precedence. While sovereign States might temporarily benefit from the novelty of this issue and the lack of established ways to address it in the context of restructurings, in the longer run ignoring contingent liabilities will prove very costly, not only to sovereign States but to all parties to a debt restructuring.

E. Alternative mechanisms for debt restructuring[37]

Since the global financial crisis, there has been growing recognition of the need to facilitate sovereign debt restructuring. Such concerns are not new. However, in the years prior to 2008, the dominant view was that the more costly a sovereign debt default, the less likely it would be to occur (see Buchheit et al., 2013). According to this view, any reduction in the costs of default would discourage governments from paying their debts and encourage over-borrowing, thereby increasing perceived creditor risks and reducing access to foreign credit. Instead, as argued above, recent experience has shown that the more likely scenario is not that governments may restructure their debts too easily, but, on the contrary, that they will delay necessary debt restructurings.

This section analyses existing proposals for a more effective approach to sovereign debt restructuring, and the extent to which they would facilitate successful and comprehensive sovereign debt resolution while also remaining politically feasible. There are broadly three types of approaches to sovereign debt restructuring mechanisms (SDRMs): a market-based approach that focuses on legal improvements to the existing contractual system; a semi-institutional approach that advocates the use of soft-law international principles to help inform and guide a restructuring process; and a statutory approach that aims to establish internationally binding rules and procedures on sovereign debt restructuring. A legally binding multilateral treaty is the ultimate objective of this approach.

These proposals differ on a number of key aspects of sovereign debt restructuring, such as which types of debt should be included, the degree of coordination and centralization of SDRMs, how participatory and transparent these should be, whether or not SDRMs should include adjudication possibilities in cases where no voluntary agreement is reached, and how consistent outcomes have to be across debt restructurings.

1. *Contractual or market-based approaches*

A number of prominent proposals to facilitate sovereign debt restructuring seek to maintain the integrity of existing market-based approaches by clarifying and strengthening their legal underpinnings, in particular by improving CACs in bond contracts (IMF, 2014). Other approaches include contingent payment provisions, clarification of the *pari passu* (equal treatment of bondholders) provision, in particular following the ongoing Argentine case, and mechanisms to limit creditor participation in restructurings by addressing the issue of sovereign credit default swaps. Contingent payment provisions are not primarily concerned with the SDRM itself; instead, they would allow future payments by sovereign debtors to be made contingent on observable economic conditions, for example through the use of GDP-indexed bonds or contingent-convertible bonds.

The main advantage of such market-based approaches is that debt restructurings remain voluntary and, at least potentially, consensual. They also open the way to gradual reform, in the sense that widespread use of such contractual proposals might help to promote debt sustainability, reduce uncertainty about outcomes and prepare the ground for more far-reaching reforms.

Market-based instruments such as collective action clauses may improve debt restructuring, but they do not prevent crises, nor do they provide the tools necessary for exiting them.

This said, the case of the CACs also highlights major limitations. As the example of Greece has shown, conventional, single-series CACs, which require the consent of a qualified majority of bondholders of every single issue, can easily be disabled by holdout creditors who buy a blocking minority. Aggregated CACs, which require a twofold qualified majority − that of the holders of each bond issue as well as of the holders of all covered bond issues − can reduce, but not eliminate, the risk of such behaviour. Yet, even the best, single-limb CACs that do not require voting by bond issue cannot guarantee that holdouts will not find ways to block the required consent (Galvis and Saad, 2004).

These CACs require the participation of 75 per cent of all covered categories of outstanding debt. While it might be difficult even for very large investors to acquire a blocking minority, the operation of such clauses – which are yet to stand the test of practice – requires that all creditors be offered identical conditions under the restructuring agreement, regardless of the conditions of their old bonds. Without this, there would be a high risk that the restructuring is achieved at the expense of some bond series. However, this condition provides a basis for inter-creditor discrimination. One-size-fits-all restructuring agreements will necessarily disadvantage those who enjoyed better conditions before the restructuring than the majority, such as creditors holding instruments with long maturities. In the end, even third-generation single-limb CACs remain structurally deficient (Bohoslavsky and Goldmann, 2015).

A purely contractual approach focused on CACs suffers from a number of additional limitations. The introduction of certain CACs might require legislative amendments in some jurisdictions in order to protect them against standard term reviews by courts. Many legal orders protect contractual parties against boilerplate terms used by one party which unduly compromise the rights of another party. Legislation would have to determine that certain CACs do not fall into this category. Moreover, CACs only apply to bond debt; if the debtor State has significant outstanding multilateral, bilateral or bank debts, they will be of little help. Coordination among different categories of creditors and the risk of free-riders taking advantage of a lack of such coordination has been an ongoing concern. CACs also adopt a very narrow approach to sovereign debt issues. They do not prevent crises, nor do they provide the tools necessary for exiting them, or interim financing during debt restructuring (Krueger and Hagan, 2005). Furthermore, CACs do not guarantee that the outcome of negotiations – which will depend on the relative bargaining powers of the parties – will be consistent with a durable solution based on a return to growth.

2. *Need for internationally accepted principles for SDRMs*

This approach aims, in principle, at an internationally accepted solution for SDRMs, and thus at a higher degree of their coordination, and possibly centralization, than the market-based contractual approach. Unlike the statutory approach (see below), it focuses on soft-law principles or guidelines, drawn from international public law. General Assembly resolutions on external debt and development have repeatedly called for consideration of such enhanced approaches to SDRMs based on existing frameworks and principles, with the broad participation of creditors and debtors.[38] An example of such principles is to be found in UNCTAD's roadmap and guide for sovereign debt workouts (UNCTAD, 2015).

Basic principles to guide sovereign debt restructuring and recover debt sustainability can be incorporated into domestic legal systems and be applied in the context of international law.

Generally speaking, a soft-law approach might define a number of principles to guide sovereign debt restructurings and address the challenges to debt sustainability. Such general principles of law usually refer to unwritten rules of behaviour or customary practices. They should be recognized in most domestic legal systems, and they should be applicable in the context of existing international law. The following are the core principles under discussion for SDRMs:

- ***Sovereignty***, which establishes the right of governments to set policies and regulate their internal affairs independently, and implement them in the public interest. This is a fundamental principle underpinning any domestic legal system, and remains the basis for economic and political interactions at the international level. The conditions under which international bodies may adopt decisions affecting States or individuals is an ongoing debate.

- ***Legitimacy***, which refers to the basic justification of a government's authority over its citizens (or of an international or supranational body over its members) and the procedures by which that authority is created, exercised and maintained. In the context of SDRMs, this principle is understood to refer to such requirements as comprehensiveness, inclusiveness, predictability and ownership. It broadly reflects the idea that SDRMs need to take into account and rectify the trend of States being less and less protected by sovereign immunities and more and more subject to the decisions of international organizations and other structures such as creditor committees.

- ***Impartiality***, which refers to the absence of bias. As such, it fosters the acceptance of decisions by generating or reconfirming trust in actors and institutions. It is closely related to the principle of legitimacy. In the context of sovereign debt workouts, the principle of impartiality refers to institutions involved in debt workouts, and includes their financial situation, the choice and actions of their personnel and the information at their disposal. The fundamental idea is that sovereign debt workouts require a neutral perspective, in particular with regard to debt sustainability assessments and decisions about restructuring terms.

- ***Transparency***, which has two dimensions of particular relevance for sovereign debt workouts: data transparency on debtor and creditor positions, projections underlying proposed restructurings and any indicator used in the context of debt restructurings; and institutional transparency so as to avoid the backroom nature of some past debt workout negotiations.

- ***Good faith***, which encompasses basic requirements of fairness, honesty and trustworthiness, and is widely accepted as a general principle of law. Good faith implies that the legal and economic outcomes of sovereign debt workouts meet legitimate expectations. As such it has a particularly important impact on all procedural elements of a debt workout − from a standstill on payments, through a stay on litigation to restraining holdouts.

- ***Sustainability***, which considers that sovereign debt is sustainable if it can be serviced without seriously impairing the social and economic development of society. In economic terms, this means that only sustained and inclusive growth creates the conditions for servicing external debt in the long run, and that conditionalities for the restructuring of sovereign debt must not undermine growth-enhancing dynamics. Sustainability constitutes an (at least emerging) general principle of law. In the course of the last few decades, the concept of sustainability has spread from environmental regulation to other policy fields, including political economy. It now characterizes large segments of domestic policy, and has received recognition in many international forums and resolutions.

Box 5.2

BELGIAN LEGISLATION RELATING TO VULTURE FUND ACTIVITIES

In July 2015, the Belgian parliament overwhelmingly adopted a bill "to combat vulture fund activities". At the heart of the new law is the introduction of a ceiling for the amount the so-called vulture funds can reclaim from government bonds bought at highly discounted prices in secondary bond markets from economies close to default. The law allows Belgian judges to stop vulture funds from claiming repayment above the discounted market price it paid for government bonds, for example at original face value.

It follows earlier Belgian legislation, adopted in March 2013, to prevent creditors' seizure of funds earmarked for development (Art 36, Loi relative à la Coopération au Développement). More specifically, the new legislation targeting vulture funds provides a legal framework to prevent non-cooperative bondholders taking "illegitimate advantage", which is defined as a manifest disproportion between the amount claimed by a creditor and the notional face value of the debt. A significant merit of this legislation is that it defines essential characteristics of vulture funds and the contexts in which their actions are not acceptable. Under the law's provisions, once a creditor's "illegitimate advantage" has been established, based on the above definition, a Belgian court can deny any order of payment that would give the creditor an illegitimate advantage if at least one of the following criteria is met: (i) the debt buy-back took place when the sovereign debtor was insolvent or in default, or when insolvency or default were imminent; (ii) the creditor's legal headquarters are in a recognized tax haven; (iii) the creditor has a track record of using litigation to obtain repayment of repurchased debts; (iv) the sovereign debtor has taken part in debt restructuring that the creditor refused; (v) the creditor has taken advantage of the sovereign debtor's debt distress to obtain a clearly unbalanced debt settlement in the creditor's favour; and (vi) full reimbursement by the debtor has adverse socio-economic impacts and/or negatively affects the debtor economy's public finances.

The law clearly undercuts any incentive for non-cooperative creditors, holdout bondholders and vulture funds to start litigation in Belgium, and makes Belgium a pioneer in government efforts to curtail the activities of such funds. This is particularly significant, as Belgium is home to Euroclear, one of the world's largest clearing houses for global financial transactions. For example, under the new law, earlier demands by NML Capital, Ltd. to freeze Argentine accounts in Belgium in the context of its holdout litigation in the United States against Argentina, would no longer be allowed, since a Belgian judge can refuse to abide by legal decisions made in other jurisdictions.

The only other national initiative relating to vulture funds to have passed the test of a parliamentary vote is the United Kingdom Debt Relief Act (Developing Countries) of 2010, which prevents vulture funds from gaining massive profits from debt restructuring in developing economies. Other national legislative initiatives to this effect, and with a particular focus on developing-country debt, have been proposed in several European countries and in the United States, but so far they have not been enacted. The United Kingdom Debt Relief Act is less stringent and comprehensive than the new Belgian legislation in a number of respects: it is limited specifically to the heavily indebted poor countries. Also, it has less stringent caps on profits that can be made from debt distress in such economies by linking those caps to the "relevant proportion" of any debt relief obtained under the HIPC initiative's formula (usually between 67 and 90 per cent). Creditors that reach a compromise agreement relating to claims for qualifying debts are exempt from this automatic debt reduction system. Overall therefore, this legislation is limited to addressing "disproportionate" profits by vulture funds rather than curbing their activities per se. By contrast, the Belgian law explicitly takes account of the wider socio-economic impacts of vulture fund activities and of their potential illegitimacy.

Proponents of such an approach based on semi-institutional, general principles have developed a range of suggestions on how to structure the institutional aspects of promoting general principles or guidelines for sovereign debt restructuring. One view is that restructuring negotiations will continue to take place in established forums or on an ad hoc basis, but will be supervised and coordinated by a new independent body, such as a sovereign debt forum (a private organization) or a debt workout institute (endorsed through a multilateral process).[39] A second, but complementary, view highlights the usefulness of semi-institutionalizing SDRMs at the level of adjudication or arbitration, but falls short of an approach based on a multilateral treaty. This includes mainly the promotion and use of specific rules and procedures, or applications of the general principles, across ad hoc arbitration processes.

One way of promoting the application of general or soft-law principles for SDRMs is through domestic legislation, such as the United Kingdom's Debt Relief (Developing Countries) Act of 2010, to tackle problems arising from non-cooperative bondholder litigation. Similarly, the Belgian parliament has only very recently (in July 2015) passed a law "in relation to the fight against the activities of vulture funds",[40] which is intended to curtail harmful speculation by such funds (box 5.2). This avenue of working through national legislation could be particularly effective if core principles were adopted in those jurisdictions in whose currencies most debt is currently issued. An obvious limitation is, of course, the danger of a lack of uniformity, coordination and consistency across different jurisdictions, as well as the possibility that only very few States will pursue this course.

Overall, a semi-institutionalized approach based on soft law but also rooted in international public law is clearly a further step towards a more permanent, less fragmented, more transparent and predictable framework for SDRMs. It has the advantage of building, for the most part, on existing mechanisms of negotiation and restructuring. Moreover, it could be scaled up in the future if it attracts enough parties. However, the main limitation of the contractual approach applies to this approach as well, if to a lesser degree: the principles are not binding, and there is no guarantee that a critical mass of parties will be willing to make more permanent commitments to these principles. This problem can only be solved through a full-fledged multilateral and statutory approach.

3. Statutory approaches to multilateral debt restructuring

In September 2014, the United Nations General Assembly passed Resolution 68/304 that called for the establishment of a "multilateral legal framework for sovereign debt restructuring processes". This represents a first possible step towards the final option, namely an international formal and statutory approach to establish binding regulations for all parties through a multilateral process. This is certainly the most far-reaching proposal for sovereign debt resolution, as well as the most challenging.

Advocates of multilateral debt workout procedures often draw attention to the asymmetry between strong national bankruptcy laws, as an integral part of a healthy market economy, and the absence of any counterpart to deal with sovereign debt restructuring. Given the unique role of sovereign actors with respect to economic, legal and political outcomes, any such procedures should meet two objectives. First, they should help prevent financial meltdown in countries facing difficulties servicing their external obligations. Such a meltdown often results in a loss of market confidence, currency collapse and drastic interest rate hikes that inflict serious damage on public and private balance sheets and lead to large losses in output and employment, not to mention a sharp increase in poverty. Second, they should provide mechanisms to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract. Meeting these goals implies the application of a few simple principles:

(a) Allowing a temporary standstill, regardless of whether debt is public or private, and whether the servicing difficulties are due to solvency or liquidity problems (a distinction which is not always clear-cut). In order to avoid conflicts of interest, the standstill should be decided unilaterally by the debtor country and sanctioned by an independent panel, rather than by an institution (e.g. the IMF) which is itself also a creditor. Such a sanction should provide an automatic stay on creditor litigation.

(b) Standstills should be accompanied by exchange controls, including the suspension of convertibility for foreign currency deposits and other assets held by both residents and non-residents.

(c) Debtor-in-possession financing should be provided, automatically granting seniority status to debt contracted after the imposition of the standstill. The IMF should lend into arrears for financing imports and other vital current account transactions.

(d) Enabling debt restructuring, including rollovers and write-offs, based on negotiations between the debtor and creditors, and facilitated by the introduction of automatic rollover and CACs in debt contracts.

There are currently two main sets of proposals for a formal statutory approach that could achieve these objectives. The first of these foresees the development, in some form or other, of a sovereign debt restructuring facility under the auspices of the IMF. This would require an amendment to the IMF's Articles of Agreement. A second set of suggestions emphasizes the need for a more permanent and impartial international institution, not itself involved in sovereign lending, and favours the establishment of an independent tribunal, whether housed in existing courts (such as the Permanent Court of Arbitration or the International Court of Justice) or newly established in its own right. In either case, any fixed institutional base would need to be established through a multilateral treaty (or the relevant modification of an existing treaty).

The essential feature shared by all proposals for a statutory approach to sovereign debt restructuring is, however, that legal decision-making in debt restructuring cases would be governed by a body of international law agreed in advance as part of the international debt workout mechanism. Also, the core purpose of any sovereign debt restructuring facility or tribunal would be to provide transparent, predictable, fair and effective debt resolution, with its decisions binding on all parties as well as universally enforceable, regardless of jurisdiction.

Clearly, establishing such a statutory solution for debt restructuring would be extremely challenging, as well as a rather lengthy process, from treaty negotiation to eventual ratification. To be effective, a statutory approach would need a critical number of signatories to its underlying multilateral treaty. In particular, it would need to take on board those economies under whose jurisdiction most external debt is currently issued. This is bound to be difficult, and there are also likely to be legitimate concerns about the nature of the powers to be vested in such an international tribunal or IMF facility, and how the powerful institutional interests that may already exist or may develop within such an entity will be governed.

The main and very important advantage of such a multilateral statutory approach is that, if successfully established, it would promote a set of regulations and practices that embody long-term objectives and principles – such as sustainable development, equity and fairness of outcomes, and transparency of process – over and above particular interests. Given the deep-seated problems of lack of accountability, partiality and an absence of legitimacy that characterize many existing debt restructuring mechanisms, as well as their fragmentation, the mere provision of a stable and clear institutional framework for sovereign debt restructuring could help render debt resolution more effective and outcomes to become more predictable through the promotion of consistency in judging cases. In addition to the obvious macroeconomic benefits from early diagnoses of sovereign debt problems and the implementation of swift action towards their resolution, the importance of a high degree of legitimacy of a well-functioning SDRM with global reach – and which has been established with the active participation of all member States and other relevant stakeholders – cannot be emphasized enough.

> A multilateral legal framework for debt restructuring should allow temporary standstill, stay of litigation, exchange controls and lending into arrears to prevent a financial meltdown in countries facing a debt overhang, and allow them to reach a debt restructuring agreement that helps restore growth and debt sustainability.

It goes without saying that the approaches surveyed here need not be mutually exclusive. It is perfectly possible to pursue improvements in existing contractual approaches, while also promoting national legal projects and soft-law principles for sovereign debt resolution, and simultaneously pushing for longer term plans for a more permanent, legally binding and institutional solution.

F. Conclusions

Recurrent external debt crises are likely to remain a major challenge to global financial governance. As shown above, a major driver of this growing indebtedness is the push factor of fast-rising financial capital inflows in the context of rapid and excessive global expansion of liquidity. Moreover, the concomitant growth of often complex and opaque financial and debt instruments, along with substantial changes in the structure and composition of developing-country external debt, have rendered their debt highly vulnerable to the vagaries of private financial markets, in particular, and in the present global economy, more generally. Even for the larger and more advanced developing economies, it is not clear to what extent they are prepared to face the manifold challenges stemming from a much higher market risk exposure of their external debts, a fragmented and ad hoc system of debt restructuring mechanisms and an overall economic and institutional environment that introduces a recessionary bias to macroeconomic adjustment processes.

Therefore, the persistent vulnerabilities and challenges posed by international financial markets make it all the more important to ensure that the debate about enhanced debt restructuring mechanisms is taken seriously. The different approaches to this issue reflect wide variations in the understanding of an economy's functioning and needs, as discussed in this chapter, which may not be easily reconcilable. Consequently, it might be prudent to adopt a gradual approach to change in this area, proceeding from the more minimalist to more far-reaching proposals. What seems clear is that, despite obvious difficulties in political consensus-building, a comprehensive, predictable, equitable and consistent framework for effective and efficient sovereign debt restructuring is indispensable and will be to the long-term benefit of sovereign debtors as well as the great majority of their creditors.

Notes

1 Though other estimates vary, according to Furceri and Zdzienicka (2011) of the IMF, such crises can reduce output growth by 5 to 10 percentage points. Moreover, the authors found that after 8 years output remains by some 10 per cent below the country pre-crisis trend.

2 See, for example, *TDR 1986*, annex to chap. VI; *TDR 1998*, chap. IV; *TDR 2008*, chap. VI; Radelet, 1999; IMF, 2001.

3 In this document, "public debt" includes publicly guaranteed private debt, and "private debt" only refers to non-publicly-guaranteed private debt, following the classifications in the World Bank's International Debt Statistics.

4 The cases of Spain and the United States provide a good illustration of this phenomenon. In 2007, the external debt held by the private sector (excluding debt related to deposit-taking corporations and direct

investment) represented 50 per cent of GNI in Spain and 48 per cent in the United States. After a sharp deleveraging process, it fell to 31 per cent in Spain and to 34 per cent in the United States. Meanwhile, general government external debt increased from 20 to 42 per cent in Spain and from 18 to 34 per cent in the United States.

5 Source: World Bank, *Quarterly External Debt Statistics – Special Data Dissemination Standard* (*QEDS–SDDS*) database.

6 Source: World Bank, QEDS–SDDS database.

7 Source: UNCTAD secretariat calculations, based on Thomson Reuters' *EIKON* debt structure analysing tool.

8 This subsection partly draws from Bohoslavsky and Goldmann, 2015.

9 The most noteworthy was the invasion of Mexico by France after the government of Benito Juárez suspended interest payments on its external debt in 1861. Another was the blockade of Venezuelan ports by the fleets of Germany, Italy and the United Kingdom in 1902−1903 to force the Venezuelan Government to pay its foreign debt to their nationals. This prompted the Drago-Porter Convention of 1907, which established the universal principle that States may not use force in order to collect claims arising from the sovereign debt of a State held by their nationals (Benedek, 2007).

10 The United Kingdom also suspended the convertibility of the pound; this forced its foreign creditors to use the resources obtained from United Kingdom debt repayments in purchases of goods or assets within the pound area.

11 See also the decision, Republic of Argentina v. Weltover, Inc., 1992, under which issuing bonds was considered a "commercial activity".

12 In all these schemes, creditors could choose between a "debt reduction option", which applied the appropriate debt cancellation rates and rescheduled the remaining debt, including ODA credits, or other options that reduced the debt burden by extending the repayment period and reducing interest rates.

13 For instance, the Paris Club obliged Pakistan and Ukraine to obtain a level of debt relief from private creditors equivalent to the Club's concessions.

14 Conditionality (especially that involving structural reforms) by the IMF and World Bank has, in fact, followed some additional goals, such as redefining national development choices according to creditors' views and interests (Akyüz, 2005). Some IMF reports have acknowledged that there are "legitimate concerns that in many instances structural conditionality may have gone beyond what can be justified in relation to the intended purpose of conditionality in safeguarding Fund resources" (IMF, 2001: 27). Moreover, a report by the Independent Evaluation Office of the IMF stresses that "the crisis should not be used as an opportunity to seek a long agenda of reforms with detailed timetables just because leverage is high, even though such reforms may be beneficial to long-run economic efficiency" (IMF, 2003a: 50).

15 Success in associating commercial creditors has been limited, and some of them have initiated litigation against HIPCs to obtain full debt repayment.

16 In the Greek debt restructuring of 2012, for instance, commercial banks holding Greek bonds were represented by the Institute of International Finance, whose members include banks, insurance companies, asset managers, sovereign wealth funds, pension funds, central banks and development banks.

17 In 1997, the IMF launched the Supplemental Reserves Facility to help countries cope with "large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves" (IMF, 1997). Subsequently, countries meeting pre-established eligibility criteria could have rapid access to short-term precautionary credit lines. The Contingent Credit Line was made available in 1999, followed by the Reserve Augmentation Line in 2006 and the Short-term Liquidity Facility (SLF) in 2008, immediately after the collapse of Lehman Brothers. As potential users did not apply to this precautionary financing, the IMF had to propose new credit lines to finally receive a number of requests: the Flexible Credit Line (FCL) in 2009 and the Precautionary Credit Line (PCL) in 2010 − with larger access, longer repayment periods and more flexibility, and without ex-post conditionality.

18 Colombia, Mexico and Poland applied for the IMF's FCL, and the former Yugoslav Republic of Macedonia and Morocco for the IMF's PCL.

19 The new legislation did not totally override the Chamberty principle, but added a "safe harbour" provision for litigation claims where the aggregate purchase price was at least $500,000.

20 See African Development Bank website at: http://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility/vulture-funds-in-the-sovereign-debt-context (accessed on 10 August 2015).

21 *GMO Trust v. The Republic of Ecuador*, (1:14-cv-09844), United States District Court for the Southern District Court of New York (settled in April 2015).

22 See, for example, European Court of Justice, *Fahnenbrock et al. v. Greece*, C-226/13 et al., judgment pending; *Poštová banka, a.s. and Istrokapital SE v. Hellenic Republic*, ICSID Case No. ARB/13/8.

23 See the report on vulture funds and human rights of the UN Independent Expert on Foreign Debt and Human Rights, A/HRC/14/21, 2010, available at: http://www2.ohchr.org/english/bodies/hrcouncil/docs/14session/A.HRC.14.21_AEV.pdf.

24 Affected countries are: Angola, Burkina Faso, Cameroon, the Congo, Côte d'Ivoire, the Democratic Republic of the Congo, Ethiopia, Honduras, Liberia, Madagascar, Mozambique, Niger, Sao Tome and Principe, Sierra Leone, Sudan, the United Republic of Tanzania, Uganda and Zambia.

25 *Donegal International Ltd. v. Zambia*, High Court of Justice (England and Wales), [2007] EWHC 197 (Comm.).

26 United Kingdom Debt Relief (Developing Countries) Act 2010.

27 See *Allied Bank International v. Banco Credito Agricola de Cartago*, United States Court of Appeals, 2d Cir., March 18, 1985 (757 F.2d 516); *Pravin Banker Associates v. Banco Popular del Peru*, 109 F. 3d 850, 854 (2d Cir. 1997); *Elliot Associates v. Banco de la Nación and the Republic of Peru*, 12 F.Supp. 2d 328 (S.D.N.Y. 1998).

28 See, for example, Federal Constitutional Court (Germany), cases 2 BvM 1-5/03, 1, 2/06, decision of 8 May 2007, BVerfGE 118, 124. For ICSID cases, see Waibel, 2007a.

29 Supreme Court of New York, *Crédit francais, S.A. v. Sociedad financiera de comercio, C.A.,* 128 Misc.2d 564 (1985); *EM Ltd. v. Argentina*, Summary Order, 05-1525-cv, 13 May 2005 (obiter dictum lacking precedential value).

30 See, for example, the case concerning judicial immunity for Argentina in Italian courts (Corte Suprema di Cassazione, Sezioni Unite Civile, 21 April 2005), and the holdout litigation cases before Argentine courts (Juzgado Nacional en lo Contencioso Administrativo Federal N° 1, 12 October 2006).

31 Federal Constitutional Court, Case 2 BvM 1/03 et al., decision of 8 May 2007.

32 NML Capital Limited (Appellant) v. Republic of Argentina (Respondent) [2011] UKSC 31.

33 *Abaclat v. Argentine Republic*, ICSID Case ARB/07/5, Decision on Jurisdiction and Admissibility, 14 August 2011; see also Gallagher 2011; and Waibel, 2007b. On the question as to whether sovereign debt can be regarded as direct investment, see *Fedax v. Venezuela*, ICSID Case ARB/96/3; *Československa obchodní banka v. Slovak Republic*, ICSID Case ARB/97/4; however, see also the restrictive view of the tribunal in *Poštová banka, a.s. and Istrokapital SE v. Hellenic Republic*, ICSID Case No. ARB/13/8.

34 Cf. ITLOS Case No. 20, *ARA Libertad (Argentina v. Ghana)*, Order of 15 December 2012. The ITLOS ordered the release of an Argentine vessel sequestered by the Ghanaian authorities.

35 *Elliott Associates*, Brussels Court of Appeals, 8th Chamber, General Docket 2000/QR/92, 26 September 2000.

36 *NML Capital, Ltd. v. Republic of Argentina*, No. 08 Civ. 6978 (TPG), United States District Court for the Southern District of New York, Order of 23 February 2012: "Whenever the Republic pays any amount due under […] the [Exchange Bonds]… the Republic shall concurrently or in advance make a 'Ratable Payment' to Plaintiffs. […] Such 'Ratable Payment' shall be an amount equal to the 'Payment Percentage' multiplied by the total amount currently due to [Plaintiffs]. Such 'Payment Percentage' shall be the fraction calculated by dividing the amount actually paid or which the Republic intends to pay under the terms of the Exchange Bonds by the total amount then due under the terms of such Exchange Bonds."

37 This section partly draws on Lienau O, Institutional Options for Debt Restructuring, Background Paper for the UNGA Ad Hoc Committee on Sovereign Debt Restructuring, Revised draft 21April 2015.

38 See General Assembly resolutions 64/191, 65/144, 66/189, 67/198, 68/202 68/304.

39 For the latter proposals, see UNCTAD, 2015.

40 See: www.dekamer.be/kvvcr/showpage.cfm?section=/flwb&language=fr&cfm=/site/wwwcfm/flwb/flwbn.cfm?legislist=legisnr&dossierID=1057.

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