Unsustainable debt prevention conference: suggestions to prevent future debt crises
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UNSUSTAINABLE DEBT PREVENTION CONFERENCE
suggestions to prevent future debt crises

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UNSUSTAINABLE DEBT PREVENTION CONFERENCE

suggestions to prevent future debt crises

Results of the conference of January 30th 2007, Amsterdam

This is a summary of the nine hour discussions held at the unsustainable debt prevention conference. Some remarks were supported almost unanimously while others were received sceptically. Purpose of the conference was to stimulate the debate and therefore both kinds of suggestions and recommendations are included, but it should be kept in mind that they do not reflect the view of all keynote speakers or participants. The last page contains an overview of the most important suggestions made.

The conference has been organised by students from the Law and Economics Faculties of the University of Amsterdam, lead by Antoinette Vlieger, lecturer and researcher at the Law Faculty and Margriet Tolsma, Third Chamber member 2005. Herewith we would like to thank the students and sponsors who have made this event and the publication possible:

Keynote speakers and panel members
Paul Arlman (Chairman) – Plan International
Vikram Nehru – Director Economic Policy and Debt Department World Bank
Geske Dijkstra – Erasmus University Rotterdam
Ariel Buira – Director G24
Jan Willem Gunning – University of Amsterdam
Henk Brouwer – Director Dutch Central Bank
Julien Rencki – Secretary General Paris Club
Evert Houtman – Dutch Ministry of Finance
Wade Mansell – Kent Law School
Khalid Sheikh – Director Emerging Markets and Multilateral Institutions ABN AMRO
Sweder van Wijnbergen – University of Amsterdam
Sony Kapoor – Freelance consultant to several NGOs and the World Bank
André Westerink – Dutch Ministry of Foreign Affairs

About ninety participants joined the discussions, including NGO members, scholars and policy writers.
Setting the stage

In the decades following decolonisation, developed countries supplied developing countries with loans and grants either through multilateral channels, e.g. International Financial Institutions (IFIs) such as the World Bank or the International Monetary Fund (IMF), or through bilateral channels. Loans were of course issued on the condition that they would be paid back in full, but countries that failed to meet their obligations faced no real difficulties in obtaining new loans. Political considerations were often decisive; the Cold War was dominating the scene and loans and grants were regularly used as a geopolitical instrument, not just to further economic development or for creditors’ profit.

The result was a significant debt burden which became a problem particularly when after 1989 developing countries had lost much of their strategic value. This led to several financial crises. In 1996 the Heavily Indebted Poor Countries (HIPCs) were granted conditional relief, after which they were able to obtain new loans. In 2006 another large round of multilateral debt relief lightened the burden. Relief was largely coordinated through the Paris Club. Loans, grants and relief became more and more conditional and the IMF designed the Debt Sustainability Framework (DSF) to prevent future crises. Nevertheless, many experts foresee that unless more measures will be taken, new rounds of debt relief will be needed every five to ten years.

In the meantime, issues such as Good Governance and the Millennium Development Goals (MDGs) had appeared on the international agenda. G8 summits’ results contain phrases like “make poverty history” and “help Africa” (although many consider the follow-up on these promises to be disappointing). Voices were raised against dictatorships’ easy access to money for military expenditures or Swiss private bank accounts and public opinion slowly became a force to be reckoned with. Yet at the same time, the end of the Cold War unleashed a period of unprecedented market liberalism and a focus purely on quantified data and statistics. Last but not least, the 90s saw the emergence of China, the Asian tigers and several wealthy oil-producing countries. These countries have built up substantial financial reserves which they want to invest in financially or politically interesting projects.

Shortcomings in the debt cancellations

Although the debt relief of 1996 and 2006 has generally been welcomed with applause, many feel that the measures taken have been a good start, but certainly not enough to deal with the serious problems. The Multilateral Debt Relief Initiative (MDRI), which cancels all claims of the World Bank, the IMF and the African Development Fund on countries that have reached the completion point of the HIPC Initiative, is, according to critics, not the solution; a lot of debt relief money flows to just a few of the most heavily indebted countries and the overall scale is too small to make a real difference. Also countries with disastrous policies get into trouble deepest. As they currently receive more aid and more debt relief, they are in a way rewarded for their bad governance. Another downside is that creditor countries made promises when they were in the spotlights, but during the execution phase after the media had left, they didn’t always keep those promises.

Furthermore relief is often paid out of Official Development Aid (ODA) budgets, which means existing budgets are redirected. If the developing country no longer serviced the debts concerned, the relief actually leads to a decrease in net flows available for development. This effect becomes even larger if the ODA budgets pay (creating money flows from development aid departments to financial departments) the nominal value of the cancelled debts, in stead of the real value. One could say that this way the creditor country actually makes a profit. The Paris Club currently has no opinion on how countries pay their promises on debt relief, but many stress the importance of rules thereupon. The discussion on debt relief is, according to critics, currently not very transparent. The Paris Club however insists that the rules it applies are clear, transparent and well-tailored to address the specific needs of the different debtor countries’ situations. Moreover, being embedded in the international financial system, the Paris Club works closely not only with creditor and debtor countries, but also with the IMF and market participants.
Last but not least: during the relief efforts, many new loans have been granted. Some state that
in stead of loans, only grants should have been given in order to achieve the MDGs. Others say that,
depending on the default rate, loans may actually create a larger net flow to development countries:
successful loans will be paid back and then the money can be loaned again. The money for grants can
only be spent once. Loans also lead to more discipline and therefore some experts assume aid in the
form of loans to be more effective; others however disagree.

**Debt Sustainability Framework**

The current method used to prevent future debt crises is the Debt Sustainability Framework, created by
the IMF and the World Bank. Aim of the framework is primarily to help those Low Income Countries
(LICs) which do not have sufficient access to the private financial market due to large default risks, in
order to help these LICs in their development, so that in the long run they will no longer need the
multilateral institutions and bilateral channels for their money flows. DSF does not guarantee that a
debt crisis will not happen again, but there is reason to believe that the implementation will decrease
the number of cases of debt distress.

The IMF and the World bank gather a variety of data on debts, expenses and tax and exports
revenues. After this survey a risk rating is made: high, medium or low risk. Depending on this rating, a
debt policy is established under the DSF. New loans have to be consistent with the capacities of a
country. High risk countries should in the view of the IFIs be helped only with grants, not with new
loans, but according to the World Bank many creditors continue to give new loans to high risk
countries. Others say that it’s the multilateral institutions themselves which give out too many new
loans.

According to the World Bank, the DSF can be characterised as being based on empirical
evidence, as proactive and forward looking, country specific and transparent. Nevertheless, several
parties stress the importance of more transparency concerning the DSF both on used data and on
methods. Also more cooperation with the private sector is needed, the private sector currently writes
its own risk assessments. The IFIs should cooperate not only with all creditor countries but also with
banks and rating agencies.

The Wold Bank has calculated that over the past forty years the LICs have on average been in
debt distress for sixty percent of the time. Generally debt distress occurs when debts are too high in
relation to the financial inflows (mainly the revenues from their export) of a country. Due to the
volatility of prices of raw materials, loans which seemed sustainable ex ante, can turn out to be very
unsustainable ex post. More than fifty LICs are dependant on the exports of one or two products and
are therefore extremely vulnerable for changing prices for these products on the world market.

In the 1960s the IMF had instruments to act in such circumstances, but nowadays interfering
with the free market is considered undesirable. Next to that, the possible impact of IMF actions in this
field is becoming insignificant due to the growing scale of the international financial and commodity
markets. A suggestion for improvement here is the Tobin tax; a tax on international money
transactions, which would slightly stabilize currency flows and which could be used to stabilize prizes
of certain raw materials.

There is also a clear relation between debt distress and the functioning of the institutions in a
country. Currently many Central Banks in these countries do not have sufficiently accurate and
adequate data to properly inform and advise policy makers. The World Bank tries to help LICs with
technical assistance programs.

In managing the existing debt burden not enough attention is given to domestic debts. The
World Bank is worried about the fact that domestic debts are almost never added when the total debt
of a country is calculated, but if these debts are too high, they can be just as crippling as foreign debts.

**Free riders and the Paris Club**

The Paris Club is an informal organisation of nineteen states that coordinates debt relief. Cancellation
leads to an increase in the real value of the non-canceled debts of a country, which creates the risk of
free riding and therewith the risk of no creditor wanting to be the (first) one granting cancellation. A
related problem is the possibility that grants will be used by the receiving country to pay off other existing debts in stead of spending it on development.

Apart from coordinating relief quantitatively, the Paris Club has (in 2003) agreed on the Evian approach, by which Paris Club creditors have agreed to consider debt sustainability for countries that are not eligible to the HIPC Initiative. According to the Paris Club, a successfully coordinated debt relief will result in an increase of net transfers to developing countries, which is necessary for development.

According to critics the Paris Club in the end is nothing more than an organisation that represents the interests of rich countries and only wants to restructure and guarantee the pay back of debts in the interest of its rich members. These critics feel that economic development is of no concern to the Paris Club.

This difference of opinion returns in the discussion on creditor countries which are not members of the Paris Club. The nineteen countries feel that countries like China profit from their activities by providing new irresponsible loans. They would like to see more creditor countries joining their ranks, or some means to force compliance by all creditor states worldwide. Others are of the opinion that China is only doing what the members of the Paris Club have been doing for decades. Some say that China is currently supplying poor countries with urgently needed funds, but others respond that nobody knows what China’s conditions are and that therefore we just cannot say whether development countries are indeed getting a good deal or not.

**Odious Debts and International Law**

Certain loans have been granted to dictatorial or corrupt governments. The poor populations of the countries concerned have never benefited, but nevertheless they have to pay it back under the rule *pacta sunt servanda*; agreements must be upheld. Many legal scholars and non-governmental organisations feel that in this respect international law has shortcomings which should be dealt with instantly.

Under current rules dictators are the legal representatives of countries. A switch towards democracy does not alleviate states from previous obligations. Different solutions have been proposed. The first possibility is to work out a proper odious debt doctrine; countries would no longer be obligated to pay back loans (i) which have been given to governments which did not represent the population (ii) if these populations have not benefited from the loans and (iii) the creditor could have known this. This would create a risk for creditors, which would lead to highly needed due diligence from their sides. At the same time a switch towards a parliamentary system would be financially rewarded, giving the young and fragile democracy a larger chance to success.

Opponents of this suggestion say that it will be very difficult to legally define odious debts. Most people agree that the rules should only be applied to future debts, not to existing debt, based on the legal principle that rules may not be changed half-way. Still others argue that the treatment of debts should be based mainly on financial grounds, so that also private creditors and non-members of the Paris Club can apply the same treatment.

The second suggestion is to incorporate the rules on representation and agency from national legal systems into international law and apply these on states. Criminals cannot with the use of guns become the legal representative of a corporation; one cannot loan money in the name of a corporation to which one has gained power by force. Likewise, one should not be able to do so in the case of states. The third suggestion is to set rules under which states can file for bankruptcy, which would allow states to start with a clean sheet in the same way individuals and entrepreneurs can do in many countries. Opponents fear that all the suggested measures, but especially the last, will worsen access of poor countries to financial markets.

**Shortcomings in the current institutional framework**

In the multilateral field the IMF and the World Bank are the most important players, but many observers feel that particularly the IMF is in an institutional crisis. The Fund’s voting system, which was designed over half a century ago, currently neither represents the present scale of the economies involved nor the respective powers or interests of its members. It no longer is – as originally intended
– an organisation that both receives from and lends to all member states in order to guarantee international financial stability. It now receives its funds mostly from Western countries and lends to developing countries, which has created a division between haves and have-nots. Many fear for the institutions’ ability to ignore pressure from certain Western countries to adjust policies for geopolitical goals, although the Fund denies this allegation. Representatives from both organisations say they try to be as transparent and objective as possible by publishing the used data and methods on their websites.

Since the richer member states have not used the services of the Fund for the last thirty years, they have become less interested in replenishing the funds and more in conditionality. There is much debate on the effect of the current conditions. Data show that countries that have more agreements with the IMF have a worse score on issues such as good governance and corruption. This of course is no evidence that the agreements with the IMF are the cause of corruption and of the lack of good governance but it also does not support the claim that cooperation with the IMF leads to better governance.

Most participants to the conference agree that too many different conditions per loan work counter productive. Creditors should communicate and cooperate more in terms of conditions set. Nevertheless conditionality always leaves manoeuvring space and thus only works if the lending governments feel the measures demanded are indeed necessary. Loans and grants therefore should be more reward oriented in stead of condition oriented.

The suggestion to give the European Union one seat in the Board of the IMF, in order to provide more seats to developing countries, isn’t greeted with applause. The result could be that a few large blocs would be governing the IMF and this would limit the manoeuvring room for developing countries, rather than increase it. Furthermore, one European seat cannot be arranged without further political unification in Europe. There is more support for the suggestion to end the double role of the IMF. The IMF is both a controlling & policy writing institution and a creditor, and it may be better to separate these roles.

Another suggestion to improve the institutional setting is to get the national parliaments of development countries more involved in both policies concerning new loans and the conditions for relief. Many other suggestions for debt management tend to be (viewed as) neo-colonialist, but by actively involving parliaments, the powerbase of parliaments can be improved, as well as ownership of policies and success of development strategies.

**Export Credit Agencies**

Export Credit Agencies (ECAs) stimulate exports to financially less creditworthy states. The result of their work, according to the proponents, has been that Low Income Countries have better access to financial means to invest in economy stimulating projects such as road or harbour construction. Not everybody is convinced of the good intentions of the ECAs. On several occasions they have backed transactions which helped dictators to oppress their people.

ECAs have also played a role in the global debt problem and more often than not, the cancellation of these debts have been financed with ODA money, resulting in a cut back on health and education funds in order to pay for the expenditures of previous corrupt leaders. Especially NGOs stress the importance of not letting the poor become victims of relief by using ODA for ECA debt rescheduling.

The most drastic suggestion made, is to abolish the ECAs altogether, because the impact on the economy of the industrialised countries is negligible, while the impact on the developing countries is, according to these critics, devastating. Others propose that all ECAs should be legally bound to publish their activities to promote transparency and to prevent securing of too abject transactions. They are currently subject to rules and regulations set by – apart from their national governments – the WTO or the OECD to prevent their activities from causing unfair competition. Therefore these two organisations may be the best forums to promote such rules on transparency.

Furthermore it is suggested that ECAs should all implement the Debt Sustainability Framework in their policies, exchange more information with the IMF and the World Bank, comply with the OECD Sustaining Lending Policy and cooperate more intensively with commercial parties.
It’s not about numbers, it’s about people and their rights

Many observers feel that the debt issue is treated too much as a purely financial issue. With the current focus on economic analyses, they feel it is often overlooked that behind the data, there are millions of people who are in need of food, health care and education. Debt relief shouldn’t just be about numbers and statistics, but about human rights, development and achieving the MDGs as well. The debt burden withholds certain countries from their obligations on the socio-economic level and therefore the population is denied some of its basic human rights. Next to the economic and legal viewpoint, the moral aspects need proper attention.
Summary of suggestions and recommendation:

Financial:
- Debt relief and crisis prevention should never be treated as solely financial issues. It is about poverty and basic human rights as well, which may never be overlooked.
- Relief should be based on real, not on nominal values of debts.
- The Paris Club countries should make sure that the promises underlying the existing relief initiatives are kept by all its member states. These initiatives should preferably not be paid with ODA money. Cancellation of ECA debts should never be financed with ODA money.
- Better calculations must be made to see if in specific situations loans or grants create larger net flows to developing countries.
- Debt relief should be conditional not on the signing of an agreement with the IMF, but on the compliance thereto, and the rules should not be changed along the way.
- It should be made sure that aid and relief policies do not reward countries with bad policies but only those countries actually making progress. Yet to make sure that poor populations do not pay the prize for bad policies, redirect flows away from governments to grass root organisations.

Institutional:
- Bilateral aid, debt relief and their respective conditions, should be better coordinated to improve efficacy of developing countries’ governments: too many different conditions create unworkable situations, separate bilateral negotiations are too time consuming.
- The double role of the IMF as both a policy-writing & controlling organisation and a creditor creates a moral hazard and should therefore be ended. The original task division between the IMF and the World Bank (financial stability versus aid) needs to be re-emphasized.
- Voting systems in international forums, especially the IMF, need to be reformed.
- In restructuring the existing debt burden, domestic debts should also be taken into account. Financial institutions world wide should be requested cooperation.
- Conditions of aid and relief should be made more in line with the views of national governments and parliaments to improve adherence.
- The International Financial Institutions and the Paris Club should organise closer cooperation with parliaments of developing countries to improve good governance and the powerbase of those parliaments.
- Debtor countries should – just like creditor countries – join forces in debt management.
- The issue of the dependency of many LICs on the volatile markets for raw materials should be addressed. Possibly the gains of a Tobin Tax on international currency flows could be used to stabilize prizes of development countries’ most important export products (to be organised by the UN).

Legal:
- Within the framework of the WTO rules of international law should be written to make ECAs obligated to give full openness on their transactions to mobilize the public in reviewing their activities.
- Either the IFIs or the UN should write clear and binding rules on future odious debts to create creditor responsibility and enforce due diligence from their sides.
- National laws regarding legal representation & agency should be integrated in international law and applied to governments.
- Both creditors and lenders should pay more attention to contractual clauses on reduced debt servicing upon shocks in financial and commodity markets.