Towards a lasting solution to sovereign debt problems

Following the global financial crisis, low-, middle- and high-income countries are seeing increased levels of sovereign debt. Today no international mechanism exists to deal comprehensively and effectively with sovereign debt problems. A lasting solution requires an independent debt workout mechanism.

A looming debt crisis

Countries all over the world are becoming increasingly vulnerable to sovereign debt problems following the financial crisis:

- Almost one third of all low-income countries (LICs) are in debt distress or at high risk of debt distress. Another third is at moderate risk of debt distress;[1]
- One quarter of countries that have benefited from substantial debt relief during the last decade are again at high risk of debt distress;[2]
- The foreign debt payments for impoverished countries will increase by one-third over the next few years.[3]

This looming debt crisis and the failure to deal efficiently with the current and past crises have **triggered debates on how to ensure fair and predictable debt workout in the future.**

The current debt crisis within the Eurozone illustrates once again that a predictable, efficient, independent and fair procedure is needed, and that once a crisis hits it is too late to define a fast and fair way out. The Eurozone crisis is also a reminder that debt and the way sovereign debt is dealt with is a highly political issue which can have enormous social and political consequences if not dealt with in an efficient way, including holding lenders to account for reckless lending and speculation.

Parliamentarians from four continents echo these concerns and proposals

Parliamentarians from four continents gathered at the Joint Parliamentary Assembly (JPA) of Africa, the Caribbean, the Pacific and the European Union in November 2011 expressed concern for the worrying debt situation of developing countries and stated that *"Policy reforms and new international mechanisms dealing with loan contraction and debt management and resolutions are therefore needed"*.

The parliamentarians highlighted that in future debt management there is a ***"need to factor in the spending needs of the indebted developing countries for the achievement of the MDGs"*** (Millennium Development Goals). The JPA called on regional organisations to develop a debt workout mechanism for indebted countries "***based on independent impact assessments of their socio-economic situation, thus reducing the scope for over-politicization of decision making on debt relief***."[5]

Why current mechanisms are not up to the mark

[1] IMF list of LIC Debt Sustainability Analyses, June 2012 http://www.imf.org/external/pubs/ft/dsa/dsalist.pdf
[2] Ibid.
[3] Jubilee Debt Campaign, The state of debt: Putting an end to 30 years of crisis, May 2012 http://www.jubileedebtcampaign.org.uk/download.php?id=1084

> *"As you know, much has been done to strengthen the architecture of the international financial system in response to the recent emerging market financial crises. But there remains a gaping hole: we lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors."*
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> Anne Krueger, former Vice President of the IMF, in 2002.

Current debt relief procedures were not intended to deal with today's complex debt structures. The Heavily Indebted Poor Countries (HIPC) Initiative is coming to an end,[4] and existing mechanisms do not reflect the actual debt situation of developing countries. Ad hoc procedures exist for bilateral debt to a few countries, and for some bondholders, however these creditors hold only a minor part of developing countries' debt.

While debt relief has freed up valuable resources in a number of developing countries, the mechanisms through which debt relief has been granted have serious shortfalls that prevent lasting solutions.

Some major shortfalls of current mechanisms are:

- They are **dominated by creditors** who are also affected parties. This creates a conflict of interest, undermines impartiality and sometimes results in politically biased decisions, including harmful policy conditionality;
- They are **ad hoc**, which means that the process as well as the outcome is highly unpredictable. This lengthens the resolution process, making it more costly for both creditors and debtors;
- They are **creditor specific**, hence they fail to assess the full debt burden of the country in question and some creditors are left out when a solution is negotiated;
- All too often, they **only make financial considerations** when assessing how much debt a country can continue servicing, and fail to take development needs into account;
- Last but not least, because of the lack of a formal procedure that ensures fair burden-sharing between creditors and debtors and assesses the validity of claims, current procedures **fail to discipline lenders** and prevent them from irresponsible lending in the future.

These shortfalls illustrate that lending to and borrowing by sovereign states and the resolution of any quantitative or qualitative debt problems are a political issue as much as a technical one.

A fair solution to sovereign debt problems requires an international mechanism that:

- Is **independent of creditors in analysis and decision making**, and is situated in a neutral forum;
- Is **comprehensive:** Includes bilateral, multilateral and private creditors treating all foreign creditors on an equal basis, and is available to all sovereign states who are at risk of debt distress or claim that their debts are illegitimate;
- Provides a **human needs based approach** to debt sustainability: When assessing a government's capacity to service its debt, takes into account the financial resources needed by a government to fulfil its obligations to provide essential services for its population;
- **Holds lenders and borrowers to account for irresponsible behaviour** by auditing the legitimacy of claims and demanding the cancellation of unjust debts based on corrupt, irresponsible or undemocratically contracted loans which did not benefit the people of the borrowing country;
- Gives all stakeholders, including civil society, the **right to be heard** and give evidence.

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[4] IDA/IMF, HIPC and MDRI - Status of Implementation, November 2011 http://www.imf.org/external/np/pp/eng/2011/110811.pdf

[5] ACP-EU Joint Parliamentary Assembly, Resolution on the impact of debt on development financing in ACP countries, November 2011, http://www.europarl.europa.eu/intcoop/acp/2011_lome/pdf/adopted_ap101.079_en_fin.pdf