

Preface

Sovereign Debt Restructurings in the Contemporary Global Economy: The UNCTAD Approach

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This Special Issue on *Principles for Sovereign Debt Restructuring: An Incremental Strategy* brings together core contributions from international legal experts to on-going debates about how best to ensure that sovereign debt can remain a viable financing tool for growth, prosperity and development, in particular in today's challenging global economic environment. This means, in the first place, building a convincing case for what constitutes a sustainable national debt, as well as engaging with legal and policy debates about how best to deal with sovereign debt that clearly has become unsustainable and requires restructuring.

For many years, UNCTAD has taken a proactive and forward-looking stance on the need to confront increasingly pressing issues of sovereign debt crisis prevention and resolution, with a primary but not exclusive focus on developing economies. Some of the contributions to this Special Issue go back to work originally advanced by UNCTAD; other contributions comment on and further develop UNCTAD's work in this area. This is a highly welcome initiative to situate UNCTAD's work and role in this field in wider scholarly contexts and to encourage further productive debate.

In this preface we comment on the growing relevance of UNCTAD's long-standing concern with sovereign debt crisis prevention and resolution in the context of recent trends and events in the global economy, as well as provide a brief overview of UNCTAD's main contributions in these areas and their rationale. We hope this will serve readers of this Special Issue as a useful entry to the manifold important issues raised in the contributions to this Special Issue.

DEBT, DAMN'D DEBT: NEW AND OLD CHALLENGES TO SOVEREIGN DEBT
SUSTAINABILITY IN THE CONTEMPORARY GLOBAL ECONOMY

Credit, and by implication debt, is the lifeblood of resource mobilization in modern economies. In the words of J.M. Keynes, "credit is the pavement along which production travels; and the bankers, if they knew their duty, would provide the transport facilities to just the extent that is required in order that the

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productive powers of the community can be employed to full capacity.”¹ Debt also is a social and institutional relationship that builds on trust and on shared information, expectations and objectives between debtors and creditors. If the ‘bankers’ do *not* know their duty – if they overextend the ‘transport facilities’ for the sake of reckless quick profit, or if they curtail them unnecessarily for fear of longer-term uncertainties – things can quickly go wrong. Instead of the ‘productive powers of the community’ being fully employed, debtors and creditors alike can end up in a vicious circle of strangulated economic activity and growing mountains of debt turned toxic.

While this applies to both public and private debt, public or sovereign debt is inherently different from private debt, in the same way in which a private sector bank is different from a central bank: Only the latter can act as a lender of last resort when a crisis threatens to affect the welfare of all citizens. Similarly, while it is broadly recognized that sovereign borrowing is often required to facilitate the financing of long-term investment programs that are too expensive and risky to attract sufficient private sector finance, it is also the only instrument that can prevent unsustainable private sector liabilities in decentralized market economies from turning into a deflationary debt spiral. By implication, how sovereign debt is managed, in both the short and longer-term, *directly* affects the wider welfare and ‘the productive powers of the community’ as a whole. This includes its restructuring, if and when this becomes an obvious necessity.

Concerns about the sustainability of sovereign debt are again on the rise, this time focusing on emerging and developing economies. For many observers, the ‘third wave’ of a debt saga, that began in 2007 in the US and subsequently engulfed European economies, is only a matter of time². At the global level, growth remains driven by an unhealthy dependence on debt. During the years of the (inappropriately termed) ‘great moderation’ (1985–2005), global debt levels rose from around \$21 trillion in 1984 to \$87 trillion by 2000, and to a staggering \$142 trillion at the onset of the global financial crisis. Since 2008, another \$57 trillion has been piled on top. This growing mountain of debt, has had both public and private components, but in both respects its accumulation has been driven by short-term expediency: It has not provided the ‘transport facilities’ required to ensure full use of productive resources and powers, instead merely propping up an otherwise stagnant and crumbling world economy.

Following several years of counterproductive austerity programs in Europe, haphazard and insufficient fiscal expansion in the US and an over-reliance by both on ‘unconventional’ but largely ineffective monetary expansion (aka quantitative easing), emerging and developing countries are now paying the price for the inevitable slowdown of already sluggish global growth in trade and real investment. The current downturn of the latest

1. JOHN MAYNARD KEYNES, A TREATISE ON MONEY, vol. II, *The Applied Theory of Money* 219-220 (1930).

2. See, e.g., *The never-ending story*, THE ECONOMIST (Nov. 14, 2015), <http://www.economist.com/news/leaders/21678220-first-america-then-europe-now-debt-crisis-has-reached-emerging-markets-never-ending>.

commodity super-cycle – itself at least in part a consequence of and deepened by – stagnant aggregate demand worldwide, has meant that highly commodity-dependent developing economies have been hit particularly hard.

But the sheer size and pace of global indebtedness is only the manifestation of a deeper malaise that affects sovereign debt. This is the unprecedented expansion, over the past three or so decades, of private over public control of the issuance of debt or credit, what is more commonly referred to as ‘financial deregulation’. Financial deregulation was part and parcel of the return to free-market policies since the end of the post-WWII global economic order, the Bretton Woods System, in the 1970s. Yet, it quickly took on a life of its own, not unlike a malicious virus. Freed of the shackles of public ‘safety’ controls, the financial industry grew beyond all (or most) expectations, endlessly mutating to add new financial instruments to its toolbox for short-term speculative profit-making, and forever expanding its lobbying powers to fend off any efforts at reregulation, in a mutually reinforcing spiral of expansion, growing lobbying powers, further deregulation and further expansion. This, in turn, is often referred to as ‘financialization’.

In the process, many advanced economy governments became the handmaidens of a financial industry that ‘globalized’ faster than they did. By now, many developing and emerging economies are being caught up in the inevitable fall-out: At stake is not simply sovereign debt that has grown too fast relative to their productive powers, although this, too, is the case for some such economies. Of equal or higher concern is the manner in which much of this debt has been contracted: With their access to multilateral loans and grants dwindling fast, many developing economies have undergone a rapid and often premature integration into deregulated international financial markets, before they had the chance and time to engage properly with ‘financial deepening’ in their own backyards. As a result, much of sovereign debt has been issued in domestic bond markets dominated by large foreign bondholders and in international financial markets, awash with cheap credit but also with highly complex contractual arrangements, usually under advanced economies’ laws and jurisdiction. In addition, public balance sheets in these economies are riddled with explicit and implicit contingent liabilities, ranging from formal guarantees of privately contracted debt, often in foreign currency, to the *de facto* obligation to bail out the private sector in the case of an economy-wide financial crisis.

In this brave new world of advanced ‘financialization’, in which central banks become marginalized as the ‘bankers of government’ and public debt is increasingly contracted from transnational financial institutions operating in a regulatory vacuum, conventional lines of demarcation between sovereign and private debt are hard to maintain in practice. At the extreme end of market-driven profiteering on the back of sovereign debt, the potentially disastrous consequences for sovereigns of this kind of ‘financial integration’ have become most obvious in the (in)famous case of Argentina v. NML Capital and three other US-based hedge funds.³ Following a protracted legal battle fought under

3. For detail see Martin Guzman and Joseph Stiglitz, *How Hedge Funds Held Argentina For*

New York law, these four vulture funds secured profits of up to 1180% from having held out for repayment at full face value of Argentine debt they originally bought at steep discounts. The Argentine legislators recently ratified this deal under pressure to re-open Argentina's access to international capital markets and, in particular, to ensure that an injunction, issued by the New York district judge in charge of this trial, could be lifted. This injunction made any payment by Argentina to its cooperative creditors conditional on its first paying the holdouts in full, thereby ensuring that Argentina would remain excluded from international capital markets until it had ceded to the demands of the four vulture funds.

Beyond the high price paid by the Argentine people to a handful of financial speculators with the lobbying power to leverage legal argument in their favor, this deal sets an unfortunate precedent for all private creditors to nations to hold these for ransom in future. After all, what is the point of being co-operative, when holdouts get their way at much higher rates of profit? Importantly, the basis for the 'vulture' type of financial speculation is not even the 'conventional' approach to such speculation – that of beating the markets and of taking risks on bets about the future economic performance of an economy or a sector - but rather, and from the outset, that of exploiting existing legislation and the lack of a multilateral framework for sovereign debt restructurings for exorbitant profit.

In such conditions, it is difficult to see how credit can provide the 'transport facilities' required for the full use of the productive capacities of a community. Or how public debt can serve its core purposes of smoothing over short-term fluctuations in private economic activity and of ensuring that initially high-risk and high-cost but transformational real investment is financed appropriately, in advanced and developing economies alike.

UNCTAD ON SOVEREIGN LENDING, BORROWING AND DEBT RESTRUCTURING

UNCTAD has been an active advocate of orderly workout procedures for sovereign debt since the late 1970s when, with the rise of free-market policies and a shift to monetarism in advanced economies, problems of sovereign debt sustainability became a major concern again, at the time in particular in Latin America. In 1977, UNCTAD called for explicit principles for debt rescheduling and in 1980, its Governing Body endorsed Detailed Features for Future Operations Relating to the Debt Problems of Interested Developing Countries. Throughout the past three decades, UNCTAD has continued to highlight the need for a coordinated international effort to establish fair and efficient ground rules for sovereign debt restructuring, in its flagship annual Trade and Development Reports⁴ and in numerous reports to the UN General Assembly on external debt sustainability and development since 2001.

Ransom, NEW YORK TIMES (April 1, 2016), http://www.nytimes.com/2016/04/01/opinion/how-hedge-funds-held-argentina-for-ransom.html?_r=0; and Mario Blejer, *Argentina's deal with the holdouts is a mixed blessing*, FIN. TIMES (March 31, 2016), <http://www.ft.com/cms/s/0/db6779d6-f729-11e5-96db-fc683b5e52db.html>.

4. See, e.g., the Trade and Development Reports of 1986, 1998, 2001, 2009 and 2015, available at <http://unctad.org/en/Pages/Publications/TradeandDevelopmentReport.aspx>.

Existing processes to deal with sovereign debt crises and their resolution are fragmented, slow and often result in unfair burden sharing and high economic, social and political costs for the sovereign debtor.⁵ Incentives, for debtors and creditors alike, are such that delaying any official declaration of insolvency as opposed to illiquidity is paramount: Debtor states will be reluctant to declare themselves insolvent for fear of triggering a financial crisis at home. Cooperative creditors will also have an interest to avoid any such havoc in order to preserve the market value of their assets. The collectively sub-optimal outcome is “too little, too late”. But equally importantly, once sovereign debt restructurings do get under way, a debtor has to negotiate separately with different types of creditors (bilateral, multilateral, private) for different types of debt contracts (bonds, loans, etc.). Different courts will have different interpretations of the same contractual clause and can impose a wide array of rulings, as evidenced in the case of Argentina vs NML Capital and other vulture funds.

In view of this unsatisfactory situation, UNCTAD has argued that orderly workout procedures for sovereign debt should meet two objectives. On the one hand, they should help prevent financial meltdown in countries facing difficulties servicing their external obligations, which often results in a loss of market confidence, currency collapse and drastic interest rates hikes, inflicting serious damage on public and private balance sheets and leading to large losses in output and employment and a sharp increase in poverty. On the other hand, they should provide mechanisms to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract. Although, in the wake of the debt crises of the early 1980s, UNCTAD insisted that meeting these goals would be best served by fully fledged international bankruptcy procedures. There was an understanding that behind the institutional and judicial challenges this implied, moving forward would depend on taking a few basic steps:

(a) A temporary standstill, whether debt is public or private, and regardless of 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 the IMF, since the countries affected are among the shareholders of the Fund, which is itself also a creditor. 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 residents as well as non-residents.

(c) Provision should be made for debtor-in-possession financing, 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.

5. UNCTAD. *Trade and Development Report: Making the international financial architecture work for development* 119 et seq. (2015), http://unctad.org/en/PublicationsLibrary/tdr2015_en.pdf.

(d) Debt restructuring including rollovers and write-offs should take place based on negotiations between the debtor and creditors,.

This core position has been informed by UNCTAD's ongoing work on the international monetary and financial system, as this has evolved, its impact on global economic imbalances and on developing economies' prospects for successful structural transformation, as well as by UNCTAD's proposals for substantive wider reforms of this system.⁶

With the advent of the global financial crisis in 2007/08, UNCTAD's long-standing concern with sovereign debt crisis prevention and resolution, in particular, took on a new and obvious urgency. In response, UNCTAD established a more detailed set of 15 Principles on Promoting Responsible Sovereign Lending and Borrowing (PRSLB) between 2009 and 2012.⁷ These were the result of an inclusive and transparent multi-stakeholder process including governments, civil society organization, academia, the private sector, observers from international financial institutions (IFIs) and the Paris Club Secretariat. The PRSLB focus on sovereign debt crisis prevention and specify key responsibilities of lenders and borrowers, including due diligence, fiduciary duties, proper approval, transparency and disclosure, alongside alternatives for sovereign debt restructuring. In view of the heterogeneity of national conditions, these principles do not include specific thresholds or quantitative targets. However, they offer economic, legal and ethical guidelines for sovereign lending and borrowing. Their adoption has been encouraged by the UN General Assembly⁸ and they are noted in the Addis Ababa Action Agenda of 2015.⁹

In April 2015, UNCTAD published a Roadmap and Guide on Sovereign Debt Workouts (Roadmap, for short).¹⁰ By then, the need to re-focus on efficient and fair frameworks for sovereign debt resolution had become very clear and urgent. Not only had the European Monetary Union been embroiled in protracted attempts to negotiate a politically and economically sustainable outcome to the Greek debt crisis (as well as public finance crises elsewhere in the EMU), but Argentina had also entered into legal dispute with uncooperative holdouts on some of its sovereign debt.

The Roadmap draws together much of the legal and economic work UNCTAD developed and advanced over the years in this area. In particular, it appeals to

five general legal principles – legitimacy, impartiality, transparency, good faith and sustainability – that provide the foundation and interpretative legal framework for a step-by-step guide to a more constructive, fairer and more efficient sovereign debt workout procedure, covering all stages from the

6. *Supra* note 4.

7. UNCTAD, *Principles on Promoting Responsible Sovereign Lending and Borrowing* (2012), http://unctad.org/en/PublicationsLibrary/gdsddf2012misc1_en.pdf.

8. G.A. Res. 65/144 (Dec. 20, 2010).

9. United Nations, *Addis Ababa Action Agenda of the Third International Conference on Financing for Development*, para. 97 (2015), http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.

10. UNCTAD, *Sovereign Debt Workouts: Going Forward. Roadmap and Guide* (2015), <http://unctad.org/en/Pages/GDS/Sovereign-Debt-Portal/Sovereign-Lending-and-Borrowing.aspx>.

decision to restructure to preparing negotiations, the negotiations themselves and post-restructuring issues.

The five general principles of law to guide the practice of sovereign debt restructurings as detailed in the Roadmap have, in the meanwhile, been included in a resolution on Basic Principles for Sovereign Debt Restructuring Processes, adopted by the UN General Assembly in September 2015.¹¹ Some of the contributions to this Special Issue, earlier versions of which directly contributed to some of UNCTAD's work on sovereign debt crisis prevention and resolution, provide detailed legal argument on the potential, validity and relevance of some of these principles. Others, as mentioned, further develop and discuss UNCTAD's work and initiatives in this respect.

If and how the UN General Assembly and its member states will take forward its resolution on Basic Principles for Sovereign Debt Restructuring Processes remains to be seen at the time of writing. As its title suggests, this Special Issue advocates an incremental approach to sovereign debt restructurings, largely in recognition of the political realities of opposition to a fully-fledged binding multilateral framework for sovereign debt resolution, in particular by advanced economies that are home to leading financial centers. This incremental strategy welcomes some advances in market-based contractual tools, insofar as these help to facilitate sovereign debt sustainability and—to some extent—implement the majority rule. At its heart, however, is precisely a set of legal principles—such as those proposed in the Roadmap though of course not limited to these—that can be used to gradually influence legal and policy practice, both nationally as well as internationally, to promote sovereign debt sustainability.

UNCTAD fully supports this approach as the most constructive and sustainable way forward under current circumstances. This should, however, not distract from the fact that a multilateral legal framework remains the only truly effective and fair—since the only truly collective—solution for sovereign debt restructuring processes.

11. G.A. Res. 69/319 (Sept. 29, 2015).