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# IMF's Debt Restructuring Follies

The seemingly monolithic institution that is the International Monetary Fund (IMF) is currently facing a growing crisis of confidence. Despite the massive debt bailout of Greece, the country is mired in political discord, unemployment, deprioritization of social services and continued economic recession. Stinging criticisms have been made on what is considered the biggest IMF bailout in history, citing that financing is being funnelled primarily to maintain the stability of the world's largest economies instead of supporting economic development to fight poverty in poor countries.

The market-oriented approach to settling sovereign debt which is supported by the IMF has made its own debt relief initiatives susceptible to threats by vulture funds. The term 'vulture fund' refers to a private equity or hedge fund investing in debt deemed very weak or about to be defaulted. It buys this debt cheap and then sues the debtor for a bigger amount, leaving the debtor in worse condition. The Argentinean case, recently highlighted in international media, shows the great extents private bondholders go to in order to reap profits from economically distressed countries.

These problems have influenced the IMF to re-evaluate its own debt restructuring procedures and suggest proposals for reform. These recent events provide a stronger impetus for advocacy groups and NGOs to call for the reform of the international monetary system.

## UNSUSTAINABLE GREEK SOVEREIGN DEBT

The images of protests and riots in Greece due to government austerity measures mirrored the disagreements and criticisms inside the IMF. This year presented the sullen admission of the IMF of its mistakes in handling the first Greek bailout. In a study commissioned by the Fund, it acknowledged that it was overly optimistic in its growth forecast and debt restructuring was delivered too little too late. These factors highly exacerbated the economic recession with spillover effects across the Eurozone.

Recently released IMF documents on the board meeting minutes during the approval of Greece's first bailout in 2010 revealed significant divisions over the program's success. The Brazilian executive director, Paulo Nogueira Batista, voiced the popular criticisms of the bailout saying:

> *"The risks of the program are immense…As it stands, the program risks substituting private for official financing. In other and starker words, it may be seen not as a rescue of Greece, which will have to undergo a wrenching adjustment, but as a bailout of Greece's private debt holders, mainly European financial institutions" (cited in Wall Street Journal 2013).*

As it stands today, three years into the bailout, the country is still suffering from massive recession. The unemployment rate stands at 27% with a high level of youth unemployment which figures at 64.9% (Chan 2013). In the recent round of government approved austerity measures, job cuts will mean laying off 25,000 public sector workers, further wage cuts, tax increase, and cuts on basic social services (Withnall 2013). The effects are clearly felt. In the past few months alone, the University of Athens along with eight other national universities have suspended operations citing unsustainable lay-offs demanded as part of austerity.

## ARGENTINA VERSUS VULTURE FUNDS

Meanwhile, Argentina is continuing its long drawn out battle with the vulture fund which staged the infamous detaining of an Argentinean naval ship in Ghana in 2012. The US-based fund, NML Capital, bought bonds from an ailing Argentinean economy before its default in 2001. It paid nearly half of what the distressed bonds were worth in a secondary market. During the process of debt restructuring, majority of the bondholders accepted losses to the nominal value of their assets. NML Capital, however, refused the conditions and filed a lawsuit against the government seeking for full payment for the real value of the bonds amounting to US$ 1.6 billion (Hirsch 2012).

This is not the first time vulture funds have preyed on highly indebted countries. The same vulture fund has also bought distressed bonds for US$ 12 million from Peru and won a lawsuit for full payment at US$ 58 million (Seager and Lewis 2007). Their main aim is to reap massive profits through buying sovereign debts at lower prices and suing for the whole amount.

The World Bank has called these rogue funds "a threat to debt relief efforts". The Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) are being sidelined by these private bondholders who do not wish to participate in the initiative. Instead, they have engaged in lawsuit with many HIPC countries for a claim worth US$ 1.47 billion (Donovan 2013). This is much needed funds which could have gone to basic social services these poor countries direly need.

## THE PROBLEMS OF IMF DEBT RESTRUCTURING AND THE PROPOSED SOLUTIONS

Given the current crisis confronting the IMF and the stinging criticisms of its actions, the institution is increasingly finding itself in introspection. Last June, the IMF has published a review of the sovereign debt restructuring procedures it has done in recent years. According to the review, the problems identified were:

- Debt restructuring were implemented too little too late. This meant a need to review debt sustainability mechanisms and sovereign fiscal transparency, create ways to circumvent bailouts as largely bailouts for private creditors and mitigate the enormous cost of debt restructuring.

- The market-based approach to debt restructuring is increasingly seen to be inefficient. The Fund is looking at strengthening the contractual framework to overcome collective action problems which is highly relevant given the threats of litigations coming from vulture funds.

- It is necessary to have a clearer framework for modalities in securing financing from official lenders, especially those outside the Paris Club. This addresses the growing lending contributions of emerging economies such as China.

- There is a need to review the lending into arrears (LIA) policy although this provided some incentives to resolving external private debt (IMF 2013).

An internal attempt to find a new approach to how the Fund does debt restructuring is not entirely new. In 2002, the proposed Sovereign Debt Restructuring Mechanism (SDRM) sought to put the Fund in a proactive position to manage sovereign debt in the backdrop of the market financial crises in the 1990s. The proposal was aiming to push majority rule over minority bondholders in restructuring decisions, allowing the options for a legal "stay" against creditor claims, protecting creditor interest during the stay, and facilitating priority financing during the proceeding.

This proposal was promptly opposed by the United States, the biggest creditor nation of the IMF. The SDRM gave debtor nations a leverage vis-a-vis their creditors through the legal "stay" which gives creditors incentive to agree to a debt workout sooner to avoid debtor nations from using the stay and thus a protracted debt repayment. This blocking of the proposal points to the conflict of interest apparent in a Fund composed of developed creditor nations intending to play the lead role in providing a neutral and fair procedure for sovereign debt restructuring.

The issuance of collective action clauses (CACs) is also seen as potent solution to holdouts of minority bondholders which disrupt the debt restructuring process. CACs will in essence provide legal backing for majority bondholders to set favourable conditions for the restructuring agreement at the same time obliging minority bondholders to agree with the said changes. This was novel in that it deviated from the legal tradition of considering creditor rights as individual and not collective which means that any debt restructuring should be negotiated separately among the individual bondholders.

CACs have become popular in light of the Argentinean default in 2001 which highlighted the cost of a protracted debt workout. In 2003, Mexico became the first country to issue sovereign bonds with attached CACs and other emerging markets followed suit (Zivkovic 2005). This year, in the midst of a continuing economic recession, the European Union has started to issue new sovereign bonds with mandatory CACs. Despite the greater incentive for creditors to participate in the restructuring process, this does not entirely ensure orderly workout since debtor nations continue to possess debts acquired previously without the attached CACs.

An alternative proposal which is backed primarily by NGOs is the Chapter 9 International Bankruptcy Court proposal applied at the international level. This is derived from the US Bankruptcy Code which deals with municipal insolvencies. Similar to the SDRM proposal, it presents an institutional framework for addressing sovereign debt crises. Chapter 9 however is intended to be a binding arbitration whereas the former features voluntary negotiations among the creditors and the debtor nation.

The strength of the proposal comes from its potential to address the unsustainable debt burden of poor countries and also democratize the process of debt restructuring. Chapter 9 in the municipal level ensures citizen participation in the decision-making process and protects their rights as tax payers or public employees (Palley 2003). If applied at the international level, citizens will be represented and have the right to be heard and also to refuse the workout conditions. Debtor nations would be capable of filing a stay and the arbitration would be managed by a neutral ad hoc panel under the supervision of the UN.

## REFORMING THE SOVEREIGN DEBT RESTRUCTURING PROCEDURE

Any remaining doubts of the urgent need to rethink the way IMF influence sovereign debt restructuring has gone. The harsh and unpopular austerity measures implemented by the Greek government as part of the bailout agreement shows that even the developed countries are losing their capacity for self-determination and democratic governance. The Fund continues to be the main point of reference for determining the fiscal sustainability of indebted countries and it imposes the prescribed solutions through conditionality.

The IMF position as a creditor makes its role as a neutral arbitrator an impossibility. The system of governance inside the institution is based on the quota system and thus giving the largest contributor the power to dictate the IMF position. The institution is oriented towards protecting creditor interest and maintaining the economic stability of biggest economies over debtor country interests and poorer countries. This is the

**Paris Club's Claims* (in USD million)**

| | ODA | Non-ODA | **Total** |
|---|---|---|---|
| As of December 31, 2012, excluding late interest | 187,994.23 | 209,893.07 | **397,887.30** |

*Aggregate amounts due to the Paris Club from sovereign and other public debtors
**Source:** Paris Club Annual Report 2012

**Paris Club Members**

| | |
|---|---|
| Australia | Japan |
| Austria | Netherlands |
| Belgium | Norway |
| Canada | Russia |
| Denmark | Spain |
| Finland | Sweden |
| France | Switzerland |
| Germany | United Kingdom |
| Ireland | United States |
| Italy | |

reason why reforms within the institution are extremely limited and the SDRM proposal has not moved forward.

The Paris Club, on the other hand, is best described as secretive in its processes. It is composed of 19 creditor governments which directly negotiates debt restructuring and debt relief with the debtor nations, often recommended by the IMF. Deals made through the Club are also rife with conditionalities given that the debtor nation is not an active participant in formulating the terms. However, the rise of emerging creditor countries such as China and Brazil presents a competition to the dominance of the Paris Club.

A neutral arbitrator for debt workout cannot be found in both existing processes of the IMF and the Paris Club. It is for this reason that calls for an independent international bankruptcy court to ensure fair and effective debt restructuring procedures are intensifying. Such court must also work to ensure the democratization of the process by requiring the participation of citizens in the negotiations. This is necessary given the extent of the social effects of the conditionalities attached to debt restructuring.

Despite the riots and social discontent felt in Greece, any talk of human rights and social justice are absent in the IMF paper. The great travesty of sovereign debt is that the private sector is being paid their share through bailouts while the citizens are burdened with the consequences of a debt they had no knowledge of or control over. The troika composed of the European Union, the European Central Bank and the IMF holds nearly complete power over the fiscal decisions of a sovereign country. The fact that these institutions were not democratically chosen by the Greek citizens show the injustice of the imposed policies that directly affect their lives.

Southern nations are faced with bigger problems in dealing with debt workouts. Odious debt accrued from despotic governments which did not contribute to the lending country's development is common in their portfolio of debt. Differentiating legitimate from illegitimate debt is especially important in the context of implementing debt relief initiatives in the Global South. Citizens should not be made to carry the burden of repaying debts which did not benefit the society.

## POLICY RECOMMENDATIONS

Given the incapacity of the IMF and international institutions to make relevant changes and the associated worsening social problems of debt workout, the following are proposals that clearly outline the need for structural changes in how sovereign debt is currently managed:

### 1. Formation of a neutral arbitrator independent of the IMF

The IMF exerts so much influence through loan conditionality and determining the sustainability of sovereign debt to the point that undermines national sovereignty. The power the institution has over borrowing nations is extremely problematic especially since it represents in great majority the interest of lending countries.

Negotiations for a just debt workout is simply not possible in this context. There is a need therefore to create a neutral arbitration panel for sovereign debt which will have the capacity to determine the legimate from odious debts. It would be tasked to oversee negotiations among debtor countries and the creditor nations or institutions. This institution should be created and established under the guidance of the United Nations and not the IMF.

### 2. Creation of an international bankruptcy procedure

Sovereign debt restructuring should include provisions similar to the Chapter 9 bankruptcy law. This would protect citizens from the harsh social backlash of austerity and guarantee their rights and human dignity. This will ensure that the population and not solely the government will participate in the decision-making process during the sovereign debt negotiations. They will have the capacity to approve or reject proposals that will ultimately affect their lives. Debtor countries would be able to file for arbitration proceedings and this in turn will be carried out by the neutral panel ensuring transparency and fairness.

### 3. Protection against vulture funds

There have been significant initiatives at the national level to combat vulture funds by some countries such as France, the United Kingdom, US and Belgium. However, this is not enough to effectively address the pervasive nature of international sovereign debt and debt profiteering. Offshore entities in tax havens facilitate the work of these vulture funds. To prevent future cases, there is a need for international and legally binding standards for transparent and just financing and international debt restructuring procedures that are binding for all creditors. Mandatory financing with CACs attached should be done internationally.

**4. Strengthen campaign for citizen debt audits**

The campaign for citizen debt audits has been gaining ground not only in the Global South but also Northern countries suffering from high levels of debt. It calls for transparency in all sovereign loans past and present. This will require sifting through government information on how these financing were acquired and how these were used. Debt audits will clarify whether sovereign debts incurred are legitimate or in fact odious debt. Thus following the precedent of citizen debt audit done in Ecuador under the presidency of Rafael Correa, sovereign loans that are proven to be odious can be renegotiated and restructured.

The social and financial cost of the IMF's failures in dealing with sovereign debt restructuring has been made more apparent in the aftermath of the 2008 economic crisis. IMF policy conditionalities no longer exclusively affect Southern countries but also the once-stable countries of the Eurozone. More than ever, the international community sees the growing need to push for significant changes in how financing is given and debt restructuring is done. Transparency in financing, democratic participation of citizens, and internationally agreed and binding rules are crucial points in making this happen.

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