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Macroeconomic policy questions: financing of development including net transfer of resources between developing and developed countries

Towards a stable international financial system, responsive to the challenges of development, especially in the developing countries

Report of the Secretary-General**

Addendum

The Secretary-General has the honour to submit to the General Assembly, as requested in its resolution 54/197 of 22 December 1999, information on work undertaken by the United Nations Conference on Trade and Development on the involvement of the private sector in the prevention and resolution of financial crises.

* A/55/150 and Corr.1 and 2.

** The present report was submitted after 3 July 2000 owing to the extensive consultation process that had been undertaken, as requested in paragraph 21 of General Assembly resolution 54/197, which took longer than expected.

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Information on work undertaken by the United Nations Conference on Trade and Development on the involvement of the private sector in the prevention and resolution of financial crises

Note by the UNCTAD secretariat

1. The issue of greater private sector involvement in the prevention and resolution of financial crises and of a more equitable distribution of the cost of adjustments between the public and the private sectors and among debtors, creditors and investors has been a subject of the research activities of the Macroeconomic and Development Policies Branch of the United Nations Conference on Trade and Development (UNCTAD), the results of which are regularly made available in the *Trade and Development Report* and other publications, and of the technical cooperation activities of the Division on Globalization and Development Strategies. A major focus of the work has been the possibility of extending insolvency principles such as those existing in the national bankruptcy codes of industrialized countries to international debt. In the past crisis situations, ad hoc bailout operations by multilateral institutions have typically protected creditors from bearing the full risk of their lending decisions, putting the burden almost entirely on debtors. They have also tended to create moral hazard for private international lenders, encouraging imprudent lending practices. Such operations have become increasingly difficult to justify. The application of insolvency principles would help not only to make the resolution of financial crises in developing countries more equitable, less costly and less time-consuming, but also to reduce the probability of the occurrence of such crises.

2. UNCTAD's work on such an extension of insolvency principles has revealed that an effective framework for greater private sector involvement would need to contain three key elements: (a) provisions for an automatic standstill on debt servicing which would give the debtor the "breathing space" required to formulate a debt reorganization plan; (b) maintaining the debtor's access to the working capital required for the continuation of its operations; and (c) an arrangement for the reorganization of the debtor's assets and liabilities, aimed at sharing the adjustment burden between debtor and creditors as well as at distributing equitably the costs among creditors. The latter arrangement may involve debt rollover, extension of existing loans, and debt write-off or conversion, with the specific combination depending on the particularities of each case. There may also be a need for some institution to act as neutral umpire and facilitator, with the authority when necessary to impose a binding settlement on the competing claims of the creditor and debtor.

3. The issue was first taken up in the *Trade and Development Report 1986*[1] in connection with proposals for a resolution of the sovereign debt crisis in the 1980s. At the time, the lack of a framework governing international debtor-creditor relations comparable with that governing internal debtor-creditor relations in industrialized countries was perceived to be a hindrance to a rapid solution of the external debt problems of developing countries. *Trade and Development Report 1986* thus recommended the extension and application of national insolvency principles to international debt, arguing that, in situations of international debt crisis, debtors are "judged de facto bankrupt, with all the consequences that this entails as regards creditworthiness and future access to credits. 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".[2]

4. While in the 1980s the main problem had been the external debt owed by Governments to commercial banks, either directly or indirectly through guarantees extended to private borrowers, in the mid-1990s the external financial obligations of developing countries became increasingly private in character. Thus, the applicability of insolvency principles to protect debtors and to assure equal treatment of creditors has gained even more relevance, and the subject was taken up again in the *Trade and Development Report 1998*,[3] for consideration by the Trade and Development Board at its forty-fifth session.[4] It was stated in the *Trade and Development Report 1998* that "bankruptcy procedures are especially relevant to international debt crises resulting from liquidity problems because they are designed to address financial restructuring rather than liquidation".[5] The *Trade and Development Report 1998*

also reiterated that, in the absence of timely provision of adequate liquidity to counter attacks on a currency, the most effective way to prevent widespread defaults and bankruptcies would be through extension and application of insolvency procedures that allowed for a standstill on debt servicing.[6] It was recognized that article VIII (2 (b)) of the International Monetary Fund (IMF) Articles of Agreement might provide a statutory basis for the application of debt standstills as a central element of international insolvency procedures, through the imposition of exchange controls when a currency came under attack. A temporary introduction of such controls could be combined with existing practices for restructuring debt through negotiations. Under certain conditions, such a standstill could be decided unilaterally by a debtor country facing an attack on its currency, and then be submitted to a standstill authority. Such a procedure would be similar to World Trade Organization/General Agreement on Tariffs and Trade (GATT) safeguard provisions for emergency trade measures. It was also considered that, in order to avoid a conflict of interest on the part of IMF, which in many cases is itself a creditor to countries affected by a currency attack, it might be desirable to entrust standstill authority to an independent panel.

5. Various facets of the issue were pursued further in 1999 in an UNCTAD Discussion Paper, prepared by staff of the Macroeconomic and Development Policies Branch.[7] It was emphasized that, in order to prevent problems associated with a generalized withdrawal of capital and currency depreciation, debt standstills would need to be accompanied by temporary exchange controls over all capital-account transactions (by residents as well as non-residents) and by IMF "lending into arrears". On the other hand, such an approach would require much less funding than the bailout operations undertaken by IMF in recent financial crises, and the Fund could also help arrange emergency lending from private capital markets.

6. In a more recent UNCTAD Discussion Paper,[8] assessing the progress in various areas of reform of the international financial architecture, it was noted that no agreement had been reached as yet over the role of IMF in standstill arrangements and over the desirability of establishing an international rules-based system for crisis solution. Owing to this lack of agreement, greater emphasis was placed in the international debate on voluntary mechanisms, but mechanisms such as comprehensive bond covenants, automatic rollover options and collective action clauses designed to enable debtors to suspend payments were unlikely to be introduced voluntarily. Moreover, if such clauses were not to reduce developing countries' access to financial markets, they would probably first need to be introduced for the sovereign bonds of industrialized countries, and this was an objective that, in turn, might require international agreement.

7. The subject was also in the agenda of a meeting on the Future of the International Monetary and Financial System, organized by the UNCTAD secretariat in Geneva on 25 and 26 January 1999 and attended by 30 high-level experts, including members of Government, leading economists of IMF, the World Bank and the Bank for International Settlements and renowned international academics. The meeting was convened in connection with the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-four on International Monetary Affairs (G-24), with the aim of providing guidance to developing countries in their preparation for negotiations on the reform of the international monetary and financial system. The experts recognized that, in the area of international money and finance, Governments and central banks, even of the major industrialized countries, had been losing influence to private actors and the financial markets, and that there could be a conflict between the public interest of financial stability for long-term growth and development and the private financial sectors' focus on quick profits. As a consequence, some of them perceived a need for financial regulation in order to circumscribe the freedom of behaviour of private agents and for rules to assure that creditors took a major responsibility in solving international liquidity crises. One element of special importance in this context was the establishment of specific rules on "systemic bankruptcy" by which a large number of debtors are affected simultaneously, even though their businesses are fundamentally sound. Systemic bankruptcy has major macroeconomic consequences and should be distinguished from cases of individual bankruptcy that may arise from mismanagement of a firm but do not have such consequences.[9]

8. The facilitation of orderly workouts for cross-border private debt was also the subject of a special research project, also in connection with UNCTAD's support of the G-24. The results of this project were

discussed by the Technical Group of the G-24 at its meeting in Colombo, Sri Lanka, in March 1999, and subsequently by the meeting of G-24 Deputies and Ministers in Washington, D.C., in April 1999.[10] The research showed that the more open and less regulated financial markets are, the more they are prone to panic, because financial flows can move much more quickly and in larger volumes than goods and services, and also because financial markets operate in an environment of imperfect information. When perceptions suddenly shift, it may be rational for *individual* creditors to abruptly demand full repayment from borrowers, even though such actions make creditors *collectively* worse off as a result. It was underlined that not only public institutions including lender of last resort and financial supervisory and regulatory bodies, but also institutions and rules that assured private sector involvement, such as deposit insurance systems, and clearly defined and transparent systems for managing bankruptcies, liquidations and other forms of debt workouts, were important preconditions for the stability of any financial system. Attention was also drawn to the fact that the key principles for orderly debt workout are to be found not only in national bankruptcy procedures but also, albeit in less formalized fashion, in the workout mechanisms for cross-border sovereign debt as practised in the framework of the Paris Club and the London Club. The introduction of collective action clauses in international bond contracts was suggested as an important step towards containing international financial panic, since these would help to coordinate creditor action on standstills and debt rollovers. With respect to new financing, while IMF should explore new facilities through which certain countries can prequalify for fast-disbursing, low-conditionality loans, the private sector should also play a much larger role in providing fresh funds to countries in distress. Such new private financing should, however, be voluntary and be given senior status. It was underlined that an effective payments standstill mechanism would itself contribute to creating the stable environment needed to encourage new private sector financing.

9. The question of a more equal distribution of the costs resulting from financial crisis was discussed, from a legal point of view, at the Second Inter-Regional Debt Management Conference on "Challenges and Solutions at the Dawn of the New Millennium", held in Geneva, 3-5 April 2000,[11] in connection with the technical cooperation activities provided through UNCTAD's Debt Management and Financial Analysis System (DMFAS). It was underlined that investors in emerging market debt instruments in particular, who are rewarded by considerably higher interest rates for taking higher risk, should not be shielded from the financial consequences when those risks materialize. A reform of the international financial architecture should aim, first, at smoothing private financial flows to emerging markets in order to avoid the boom/bust pattern of the past and, second, at facilitating prompt, orderly, non-contagious workouts in crisis situations, with attendant losses falling on those who made the investment decisions. One problem that received particular attention from a legal point of view was the need for introducing clauses in the standard form of bond documentation that allowed for greater flexibility in the restructuring of debt in the form of publicly traded bonds. Moreover, there was a discussion on lessons to be drawn from recent cases involving Pakistan, Ecuador and Ukraine regarding the terms of bond restructurings.

Notes

[1] United Nations publication, Sales No.E.86.II.D.5.

[2] Ibid., annex to chap. VI ("Toward international debt reform?").

[3] United Nations publication, Sales No. E.98.II.D.6.

[4] The discussions at the Trade and Development Board were also reflected in the agreed conclusions 451 (XLV) of the Board (see *Official Records of the General Assembly, Fifty-third Session, Supplement No. 15* (A/53/15/Rev.1), part four, chap. I, sect. C), where it was stated, inter alia, that "it may also be useful to explore alternative means of crisis management that would provide safeguards against speculative attacks and disruption of markets, prevent moral hazard, and secure more equitable burden-sharing between debtors and creditors. The establishment of orderly debt workout principles could be further examined" (para. 11).

[5] *Trade and Development Report 1998* ..., part one, chap. IV, sect. B.5 (a).

[6] For a more detailed account of the procedure, see *Trade and Development Report 1998* ..., part one, chap. IV, sect. B.

[7] Y. Akyüz and A. Cornford, "Capital flows to developing countries and the reform of the international financial system", *UNCTAD Discussion Paper, No. 143* (UNCTAD/OSG/DP/143) (Geneva, November 1999).

[8] Y. Akyüz, "The debate on the international financial architecture: reforming the reformers", *UNCTAD*

Discussion Paper, No. 148 (UNCTAD/OSG/DP/148) (Geneva, April 2000).

[9] Deliberations of the G-24 Meeting on the Future of the International Monetary and Financial System, 25-26 January 1999, summary by the UNCTAD secretariat (Geneva, January 1999), mimeograph.

[10] See S. Radelet, “Orderly workouts for cross-border private debt”, in *International Monetary and Financial Issues for the 1990s*, vol. XI (UNCTAD/GDS/MDPB/6) (United Nations publication, Sales No. E.99.II.D.25), pp. 61-81.

[11] *Proceedings of the Second Inter-Regional Debt Management Conference*, Geneva, 3-5 April 2000 (UNCTAD/GDS/DMFAS/__), forthcoming.