II. Sovereign Debt Restructuring and the right to development: Challenges from an incomplete framework
SOVEREIGN DEBT RESTRUCTURING AND THE RIGHT TO DEVELOPMENT: CHALLENGES FROM AN INCOMPLETE FRAMEWORK

by Daniel Kampel and Lat.Ma research team

I. Worlds Apart Come Together: Foreign Debt and Human Rights

At first glance, foreign debt and human rights might appear to belong to two separate and unrelated fields of study. After World War II, when the question of human rights took root, scholars and practitioners were reticent to embrace both subjects as a single academic pursuit. Some pioneering and isolated efforts were carried out in the mid-1970s, but the trend lagged until the mid-1990s. During the last two decades, however, many have started to explore the wide range of connections between foreign debt and human rights. The intersection between those areas appears as soon as we extend the scope of consideration beyond the contractual duties that exist between a debtor state and its creditors, and a more comprehensive and holistic approach takes shape, considering other effects of over-indebtedness processes on economic and socially relevant aspects. In fact, a debt overhang or a high-debt trap may result (and has resulted in the past in numerous countries) in the undermining of human rights.

The connection between debt and human rights is certainly not new. But its significance was either neglected or directly ignored during the 1970s. The first wave of financial globalization, fostered by highly liquid financial markets and aggressive lending policies by international banks, threw many developing countries in Latin America into an intense indebtedness process. The connection also went unnoticed during the 1980s, when such countries struggled with unsustainable debt burdens that delayed their development processes for around a decade. International financial institutions, which then promoted misdiagnosed stabilization policies to deal with debt issues, completely disregarded any consideration on the impact of adjustment programs on the enjoyment of human rights.

More recently, however, several studies have begun to focus on the connection between debt and human rights. Some have examined the origin of debt and questioned the legitimacy of the debt taken by non-democratic governments: historically in Latin America indebtedness grew during

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1 One exception may be the study on ‘The impact of foreign economic aid and assistance on respect for human rights in Chile’ prepared by Cassese in 1979 for the UN’s Sub-Commission on human rights.
the rule of autocratic governments and dictatorships. The current UN Independent Expert on Foreign Debt and Human Rights has even introduced the concept of “financial complicity” in reference to the lending to States involved in gross human rights violations. Indeed, Bohoslavsky has argued that “foreign financial assistance might prolong the life of regimes engaged in severe, large-scale violations of human rights” (Bohoslavsky and Cernic 2014).

During the 1980s, the lingering over-indebtedness in developing economies had deep and broad effects. The debt problem – represented by high debt stocks and protracted debt-servicing difficulties, together with rationed foreign credit– conditioned and determined the prevailing economic policies of highly-indebted countries. It severely restrained policy space and narrowed the range of policy options available to governments, including many newly elected democratic authorities in Latin America. The debt issue undermined the long-standing national development strategies of affected countries and weakened the enforcement of human rights of their citizens.

The links between debt, its consequences on economic policy, and human rights have been thoroughly reviewed by many researchers. Özden (2007), for example, makes a detailed assessment of how foreign debt and the subsequent IMF-supported adjustment programs implemented in the mid-1980s through the early 1990s have caused or aggravated human rights violations among the affected nations. According to this author, the list of said rights is long and impressive. It includes the right to self-determination; various economic, social and cultural rights; the right to live in a healthy environment; and other civil and political rights. It even goes as far as including the introduction of bills restraining basic freedoms that result in the repression of organized labor in some less developed countries. However serious and relevant they all are, both at individual and social levels, we will narrow our analysis by focusing on the impact of excessive debt service burdens on a single right: the right to development, recently recognized as such by human rights international organizations.

We have organized the rest of this paper as follows: after the introduction, Section 2 examines the concept of development and the interactions with human rights. Section 3 reviews the Latin American experience in the 1980s, with special emphasis on the macro economy of the largest regional debtors of that time – Argentina, Brazil, Chile and Mexico – highlighting their similarities and differences; Section 4 presents the successive attempts to introduce innovations in the restructuring mechanisms to deal with sovereign debt problems. The final section presents the conclusions.
II. Development is also a Human Right

“The right to development is an inalienable human right by virtue of which every human person and all peoples are entitled to participate in, contribute to, and enjoy economic, social, cultural and political development, in which all human rights and fundamental freedoms can be fully realized”. Or so at least says the Declaration on the Right to Development, adopted by the UN General Assembly, almost 30 years ago in mid-1986, while Latin America was suffering from a debt crisis that halted its development for almost a decade. Far from being disregarded, this Declaration was later endorsed by the Vienna Declaration (1993), the Millennium Declaration (2000) and the Monterrey Consensus (2002).

In any case, the concept of the Right to Development lacked a more precise definition. What do we mean by development? What does this right truly entail? Scholars and officials, especially from international organizations and development agencies, attempted to fill-in the blank. The late expert Arjun Sengupta, for example, highlighted the right to development as a human right in numerous papers. He described it twofold as: “(a) a particular process of economic, social, cultural and political development, in which all human rights and fundamental freedoms can be fully realized; (b) (..) a human right by virtue of which every human person and all peoples are entitled to participate in, contribute to and enjoy that particular process of development” (Sengupta 2002).

Some scholars have elaborated on the idea of development, expanding its definition from previously used narrow economistic characterizations. Understanding development as mere increases in national output or the surge in the material resources of a country could now be considered outmoded and inadequate. Prof. Amartya Sen, a winner of the Nobel Memorial Prize in Economics, for instance, has famously advocated that development should be understood as the “expansion of the real freedoms that people enjoy” (Sen 1999) adopting a perspective that definitively coupled the goal of development with the improvement of the human condition. He also advocated that development requires the removal of major sources of unfreedom, including (not exclusively) poor economic opportunities.

The process of development and the realization of human rights are thus intrinsically connected (Buckley, 2009). The pathway to development faces multiple obstacles of diverse nature. Heavy debt burdens are certainly a major one, especially when refinancing terms are unattainable and servicing conditions become insurmountable. Furthermore, as we will stress in this paper, there

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is a clear lack of institutions that can deal with debt crisis, such as an international lender of last resort or a widely recognized framework for an orderly restructuring of sovereign debts in distress. Thus, debt crises disrupt growth processes and they negatively affect the right to development. As already mentioned, in Sen’s view it reduces freedom and in Sengupta’s it directly alters the pursuit and enforcement of human rights.

In the last two decades, the issue of foreign debt from and human rights has also been addressed by international organs with explicit mandates and competence in the promotion and protection of human rights. In 1998, the UN Commission on Human Rights (which would be replaced in 2006 by the UN Human Rights Council) appointed a Special Rapporteur on the Effects of Foreign Debt on the Full Enjoyment of Economic, Social and Cultural Rights. In 2004 the Commission requested the expert to draft general guidelines to be followed by States and by private and public, national and international financial institutions in the decision-making and execution of debt repayments and structural reform programs, including those arising from foreign debt relief, to ensure that compliance with the commitments derived from foreign debt will not undermine the obligations for the realization of fundamental economic, social and cultural rights, as provided for in the international human rights instruments. In 2012, after a long delay, discordant debates and numerous consultations the UN Human Rights Council adopted the Guiding Principles on Foreign Debt and Human Rights.

The adoption of the Guiding Principles constituted an important step forward in the recognition of the impact of debt in human rights. However, a more comprehensive effort is still needed in order to institutionalize a restructuring framework. The 2012 guidelines admit that previous official initiatives failed to deliver a sustainable framework, affecting the development perspectives of highly indebted economies. It reminded member States of their human rights obligations in the context of any external debt negotiations. It stressed that economic, social and cultural rights of the most vulnerable sectors of society should not be undermined under any restructuring arrangement. In line with our research, the report of the Independent Expert enumerates the declarations, resolutions and decisions of major United Nations conferences that have confirmed the link between debt, human rights and development. However, it is still too

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3 This Special Procedure was later renamed as “Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights.”


early to measure the impact of these guidelines on the international lending and debt restructuring practices in the medium and long run, if any.

In the meantime, countries affected by sovereign debt issues, notably Argentina and Greece, still contend with the fact that there is no institutional framework or legal mechanisms to channel this problem quickly and systematically. Greece appears to be in a deadlock. On the other hand, Argentina –which having defaulted in 2001-2002 restructured the majority (but not all) of its outstanding liabilities with private creditors in 2005-2010— is still dealing with unsettled disputes before US courts with speculative hedge funds and facing lawsuits from hold-out investors in other jurisdictions.

III. Latin America’s Debt Crises: Lessons Unlearned

Developed and emerging markets have experienced numerous debt crises in recent history. Taking a historical perspective, Reinhart and Rogoff (2009) compile all known episodes from the early financial history of the Middle Ages to more current events, such as the US financial crisis that followed the implosion of the housing bubble in 2007, and the still unresolved sovereign debt crisis that has affected the periphery of the European Union. At the time of writing, the Greek debt problem is still unresolved. It has not been addressed properly in a reliable and timely manner. The approach implemented under the auspices of the IMF and European institutions has allowed the country to replace its private creditors by official creditors, simply exchanging one type of debt for another. But it has not reduced the unsustainability of the debt, which has now reached the unbearable level of nearly 180 percent of its GDP. Such a debt level is inconsistent with the flow of income produced by the economy and the country now registers 24 consecutive quarters of constant decline. The engagement of indebted European economies to aggressive austerity programs has placed those countries on the verge of their very own “lost decade” and reveals that important lessons from major past events, such as the Great Depression or the Latin America debt crisis, still remain unlearned.

In a more reduced time span, any catalog of financial crises of the postwar era registers frequent appearances of Latin American countries. Between the mid-1950s and the mid-1960s countries in the region suffered from frequent balance-of-payments crises associated with stop-and-go cycles that characterized their economic evolution during that period. Expansions were concomitant with the accumulation of successive current account deficits. The external imbalance was later corrected by stabilization policies based on strong exchange rate depreciations and
contractionary demand policies that compressed economic activity and imports. With the following expansion, the cycle tended to repeat itself. During those decades, funding was unavailable in the voluntary international capital markets for Latin America.

The state of affairs changed in the 1970s after the first oil shock in 1973 paved the way for high liquidity petrodollar recycling. Incentives for indebtedness developed from the combination of highly-liquid international contexts and aggressive bank lending policies by American and European institutions. Latin American countries, especially those in the Southern Cone, followed debt-prone (and unsustainable) macroeconomic programs — which essentially combined the openness of the capital account and some sort of fixed exchange rate arrangement that appreciated the real exchange rate.

It must be stressed that not all debt was originally taken by the public sector: in many cases the non-financial corporate sector was a relevant actor in the process. However, once the crisis had been triggered, the private sector pushed to socialize (at least partially) its own liabilities. Important transfers were observed through different mechanisms in the cases of Argentina, Chile and Mexico in the 1980s, and contributed in this way to increasing the sovereign debt.

In the late 1970s and early 1980s, the macro dynamics were upset by successive negative external shocks: the rise in the international interest rates in 1979 and the decline in the terms of trade. Such shocks deeply affected both the balance of payments and the fiscal accounts. Prior to 1979, borrowings by Latin American countries were associated with financing the deficit in foreign trade. Gradually, under the new financial conditions, new external obligations were directed in an increasing proportion to cover the payment of interests from previously contracted financial liabilities.

Furthermore, after Mexico’s default in August 1982, voluntary credit to the region became highly rationed. It was no longer possible to finance those imbalances using external funding. In turn, those marked imbalances in the external and fiscal accounts eroded the stability and growth potential of the affected countries. Latin American economies were forced into drastic adjustment processes based on massive devaluations and the reduction in public expenditures. The continuity of state-led ISI growth strategies, which had been implemented throughout the region from the mid-1950s, ended.

We will not detail the events of that period here. In fact, several narratives and analyses exist about the economic process that slowly evolved with the implosion of the debt crisis until growth
was eventually resumed after major delays. However, by taking such a historical experience from today’s perspective, we can extend our objective to draw some potentially useful lessons, especially regarding the lack of an international lender of last resort and a sovereign debt restructuring mechanism.

Once the crisis had been triggered and countries became credit-rationed in voluntary capital markets, they engaged in policies aiming to generate significant external surpluses in order to perform their debt obligations. The debt then became the economic policy’s primary concern, at the expense of all other policy objectives, including the obligation of states to provide minimum essential levels for each economic, social and cultural right. As was recognized by the UN expert in the field, in a country with limited resources, debt repayments compete with much-needed public expenditures for social services, including education, health and housing, worsening access to basic public services and, thus, reducing the economic, social and cultural rights of their citizens.

We must stress the scope and persistence of the above-mentioned imbalances over time if we seek a clearer picture of that period. A persistent imbalance might operate through price mechanisms and financial relations, affecting the economic structure and leading to additional imbalances. In fact, inflation might affect tax revenues, or speed-up a demonetization process of the economy, making even small fiscal deficits –under external credit rationing– difficult to finance. This is a different situation from transitory imbalances that might be met with traditional stabilization policies. Persistent imbalances may affect growth capacity, as they induce changes in the structure of the economy and agents’ decisions on savings and investment.

Indeed, one of the basic problems in the 1980s was the incorrect assessment both local authorities and international financial institutions made regarding the severity of new imbalances. At first, imbalances were addressed with traditional stabilization tools. But those kinds of adjustment programs, which provided insufficient credit support, were better suited to tackling liquidity problems and not major gaps in the external and fiscal accounts. The IMF’s and other institutions’ prescription was later transformed to promote structural reforms in line with the Washington Consensus. Initiatives, such as the Brady Plan and the change in the prevailing conditions in international capital markets, provided expanded access to credit. However, by the time this occurred, macroeconomic instability, a shortage in external financing, and weak national savings rates had already acted, halting growth and damaging the existing economic structure. In fact,

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7 See Ocampo (2014).
most Latin American countries were only then able to resume growth (albeit modestly, in most cases).

The debt crisis of the 1980s halted growth for almost seven years. Growth was resumed only after some favorable changes in the international context and some sort of debt restructuring program relieved the debt burden. Unfortunately, Argentina repeated the debt cycle yet again in the following decade. It underwent a severe macroeconomic and financial crisis and defaulted once more at the turn of the century. Economist J.A. Ocampo (2012) calls the debt crisis the most traumatic economic event in Latin America’s economic history. During the “lost decade” that it generated, the region’s per capita GDP experienced a drop of nearly 8 percent, poverty increased, and the already widening gap between the rich and the poor further widened. (Bértola and Ocampo [2012]).

So far we have described the stylized facts of the process shared by the region. While these experiences share a common pattern, there are also some differences between the different cases. In what follows we review the macroeconomic particularities of the evolution of Chile. The analysis takes into account a) each country’s degree of indebtedness at the beginning of the period; b) the changes in the terms of trade; c) the relative amount of external assistance from international organizations perceived throughout the adjustment process; d) the degree of success of the policies implemented to promote exports (or replace imports), including the exchange rate policy; e) the introduction (or not) of some sort of debt restructuring mechanism. A further look into each major national case of highly indebted Latin American countries was inserted in the Annex.8

IV. Institutions for a More Efficient Restructuring

There is one aspect where sovereign debt restructuring does not differ significantly from the treatment other significant global issues, like climate change or the eventual threat from future pandemics, receive in the international arena. The world’s existing institutions still have trouble dealing comprehensively with particular kinds of problems and have failed to provide good solutions. No mechanism or framework for debt restructuring was introduced at Bretton Woods in 1944 or later by the two institutions created at that international Conference for postwar economic management. Academics have signaled this fiasco for years.

8 The Annex was prepared by a group of Latin American students that participated in EIUC’s Global Classroom on Human Rights and Foreign Debt, on May 11-15, 2015 in Venice, Italy.
As it was clear from the Latin American experience of the 1980s, the lack of a proper channel to tackle sovereign debt issues delayed the resolution of the crisis, harming both debtor nations and creditor banks. Individual negotiations between debtor countries and creditor banks (even with the participation of international financial institutions) proved to be long and uncertain. The economic prospects of the indebted countries did not improve and the creditors’ claims lost value in secondary markets. Ad hoc individual negotiations did not replace the absence of an institutionalized mechanism for debt treatment. Instead, they exhibited numerous shortcomings.

It took seven years to break the Latin American deadlock. When the Brady Plan finally recognized that debt could not be served at its face value, it proposed a “too little, too late” debt relief scheme. Despite some initial reluctance, banks were forced to participate. After its implementation, capital markets were reopened for the affected countries and growth could be resumed, although at a slow pace.

A slightly modified scenario has recurred in recent years. As was already mentioned, Argentina defaulted once again on its liabilities to private creditors in late 2001 following the collapse of the macroeconomic regime that predominated in the country during the 1990s. In 2005 (and again, in 2010) Argentina offered an exchange for the defaulted debt with a large haircut. Such offers were accepted by a vast majority of creditors (both domestic and foreign). However, the exchanges failed to deliver a final closure to the debt issue. Argentina is still involved in litigation in US Courts, as well as in other jurisdictions, with holdout creditors who have refused to accept Argentina’s restructuring offers. Current holdouts represent only a minor proportion of the debt defaulted in 2001-02.

In 2014, the US Supreme Court turned down the case, confirming the ruling of lower courts validating an odd legal interpretation of the pari passu clause – included in the original bonds – that not only favored the plaintiffs, but that also obstructed payments from Argentina to creditors who had accepted the restructured bonds. As Stiglitz (2014) and others have observed, such interpretation (now confirmed) has a negative long-term consequence: it creates incentives for non-participation by creditors in any future debt restructuring process. The judicial recognition of the right to interfere with payments to restructured creditors will hinder any future debt restructuring process for any sovereign borrower facing solvency issues.

The unresolved Argentine situation illustrates, in our view, the unfortunate standing of sovereign debt restructuring today and confirms the need for remedies. The Euro crisis has also triggered a boom of proposals in this area from diverse groups, including development experts and human rights NGOs. Target 15 of the internationally established framework Millennium Development
Goals aimed at “dealing comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term”. Still, despite the time and effort of different fora to reach a consensus, sovereign debt appears to have little weight on the political agendas of high-level international bodies, such as the G-20. No applicable law exists and there is always a legal loophole for speculative hedge funds.

The rest of this section reviews different initiatives that have contributed, in varying degrees, to the debate to establish some sort of framework for an orderly restructuring of sovereign debt in distress. As was stated above, during the last few years, there has been a one-step-forward and two-steps-back kind of progress regarding this issue. Each initiative signified a move forward, but not enough to produce a policy shift. We have not been short of ideas, but of progress. As a result, an international legal framework that would facilitate an orderly, timely and speedy debt restructuring process still does not exist.

a. Proposals by human rights organizations and development-oriented experts: A few proposals have been put forward from different sectors of civil society. They all seem to follow Kunibert Raffer’s (undated) assertion that “Safeguarding human rights makes it necessary that such arbitration mechanism includes some form of debtor protection.” Among these initiatives is Raffer’s widely discussed proposal, as well as the ideas developed by C. Paulus and S. Kargman.

Raffer suggests extending procedures from the US Insolvency Code to sovereign debtors. Taking into account that countries cannot be put under receivership, as that would contradict sovereignty and democracy, his scheme emulates Chapter 9 of the law, which regulates the insolvency of US municipalities rather than Chapter 11, which is generally applied for corporate insolvency. Raffer’s initiative favors substituting the usual insolvency judge with an ad hoc arbitration panel with the agreement of affected parties, instead of introducing a new international legal institution. Hence, the process becomes an arbitration process that follows predefined rules and principles. It would provide bankruptcy protection and would be binding for all creditors. According to Raffer, the procedure would also open the process for the broad participation of civil society and would foster the affected parties’ “right to be heard”.9

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9 In the same vein as Raffer, but with a more private orientation, Richard Gitlin and Brett House (2012) outlined a “non-statutory, non-institutional, un-codified Sovereign Debt Forum” as a venue for debtors and creditors to negotiate.
In contrast, the Paulus & Kargman initiative consists of establishing a sovereign debt tribunal under the auspices of the United Nations with the creation of an Insolvency Chamber in the International Court of Justice (Kargman and Paulus 2008).

b. **Proposal by the IMF:** In 2003 the IMF proposed a twofold procedure for adjudicating sovereign debts. On the one hand, it promoted a contractual approach based on Collective Action Clauses (see below); on the other, it favored the adoption of a statutory approach, titled the Sovereign Debt Restructuring Mechanism (SDRM), which would have established a separate entity to facilitate the restructuring process.

SDRM would have consisted of an independent bankruptcy forum, created by an amendment to the Articles of Agreement that originated and rules the IMF. Such forum would have been vested with the jurisdiction to facilitate the restructuring process and would have been binding for all of its members.

The bankruptcy forum would have established a bankruptcy system derived from the insolvency law. There were three particularities in the proposed system. First, upon request, the debtor could secure a stay on all creditor claims. Second, the creditors would have the power to extend the length of the stay should extra time be needed to break an impasse. Third, creditors would be encouraged to subordinate their outstanding claims to any new loans in order to encourage fresh lending.

The initiative lacked the necessary political acceptance. As Rogoff (2012) described, the proposal faced sharp opposition not only from creditors who feared that the IMF would be too friendly to problem debtors, but also from emerging markets that foresaw no near-term risk to their perceived creditworthiness. The healthy borrowers worried that creditors would demand higher rates if the penalties for default softened.

c. **Innovation in contractual technology: Collective Action Clauses (CACs):** A valuable (but limited) instrument consisted of introducing CACs in bond contracts. CACs make it possible to amend contract terms if a supermajority of holders agrees to a new term for that particular commercial paper. The purpose of these clauses is to reduce the incentive for individual creditors to hold out and not to participate in a restructuring process in the hope that they are paid in full agreement with the original terms of the debt contract. In recent years, the use of CACs in sovereign bonds has become much more common.

Partly as a reaction to the Argentine and Greek cases (see above), the International Capital Market Association (ICMA) has published, revised, and updated the recommended text for collective action clauses to include the terms and conditions of sovereign debt securities. The use of these new terms in sovereign notes is intended to facilitate future sovereign debt restructurings and avoid the flaws raised by such cases.
Under the new standard model of CACs, the issuer can – as always – ask the holders of each bond series to change the prevailing terms. (If three-quarters of the holders of a particular bond series agreed to the new terms, it would be binding for the remaining minority). The issuer would now be able to survey the holders of multiple series at once. If at least half of each series and two-thirds of all outstanding debt agreed to the new terms, the remaining creditors would be bound. Finally, the issuer could interrogate holders of multiple series at once but take only a single vote across all affected series. If three-quarters of the total approved the new terms, the remainder would be bound. That is, the agreement would bind all holders, regardless of whether they voted in favor or against the new terms. Consequently, dissenting holders would be barred from bringing private actions to courts. Greece used a similar procedure to restructure its domestic debt. The widespread inclusion of new CAC terms is a step in the right direction and significantly mitigates the problems. However, they have been oversold in the financial media. There are still limitations on the generalized use of CACs: they do not provide for coordination across asset holders (for example, bondholders vs. syndicated loans claims) as would a comprehensive framework. They only cover a certain segment of the external debt and do not solve over-indebtedness problems.10

d. On September 9, 2014, the General Assembly of the United Nations approved Resolution 63/304 which supported a new bankruptcy process for sovereign debt restructuring. Progress in this line of work still needs to be seen.

V. Conclusions

The prudent use of loan funds and effective debt management can effectively contribute to a country’s development. In economic policy, prudence has to rule over the tendency of excessive loan taking by debtors and aggressive lending policies undertaken by creditors in liquid markets. As there are no institutionalized mechanisms to deal with sovereign over indebtedness, debt negotiations are excessively lengthy: they prolong economic crises and their outcome is uncertain. Experience shows that, under the prevailing non-system, by the time an agreement has finally been reached, both debtors and creditors have accumulated great losses. There is a coordination problem among creditors, leading to the existence of holdout agents. Thus, an international debt workout mechanism, which is absent in the current international financial architecture must be created.

10 See Galpern (2014) on the limitation of the use of CACs.
Different approaches have been proposed to establish such mechanisms, but the lack of political support for their adoption has led to the current situation. One of the main criticisms against such mechanisms is that it would encourage a more opportunistic behaviour by debtor nations. However as past experience shows and leading institutions have recognized, the problem historically has not been that countries have been too eager to renege on their financial obligations, but often too reluctant. (Blustein 2006). Policymakers often have incentives to postpone the moment of recognizing they don’t have alternative choices. (Levy-Yeyati and Panizza 2010)

The lack of an international lender of last resort and the lack of an internationally recognized restructuring framework worsens the situation for countries facing distress. The review and reform of the current situation is essential in order to eliminate uncertainties and keep sovereign lending operational. The introduction of such a mechanism would be a step forward for the current status quo.

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I. ANNEX

The Case of Argentina

by Rocío Comas

A. The Military Dictatorship (1976-1983) and its Economic Policies

After the March 1976 coup d’état, Argentina’s de facto government headed by a Military Junta, favoured free trade doctrines as a remedy for the economic turmoil of the period and the obstacles to development resulting from three decades of excessive state intervention. José A. Martínez de Hoz was appointed Minister of Economy and assigned the task to stabilize the economy at any cost, be it political or social.

The Minister of Economy’s policies were based mainly on the idea that the fiscal deficit was the primary cause of inflation and low growth. Previous governments had routinely over-regulated industries, protected markets, and tolerated major inefficiencies. To stimulate growth, the military abandoned the country’s state-led import substitution industrialization strategy (ISI) and liberalized most markets. The regime increasingly opened its economy to international trade by reducing tariffs and liberalized its financial system, letting the market set the interest rate. From the International Monetary Fund’s perspective, Argentina’s actions were exactly what the country needed to stabilize its economy.

In addition, between 1974 and 1980, the oil crisis led to an extreme liquidity of Western banks as the OPEC countries were depositing the dollars coming from petrol exports. This liquidity created a financial situation in which handing out loans to some developing countries was deemed an opportunity worth considering. As a result, money flowed into Argentina: Between 1976 and 1980, the country’s financial sector witnessed a 45-percent increase in loans from international banks.

Capital inflows had an initial positive impact on few productive sectors, but in light of an unsustainable macroeconomic scheme and mild financial regulation, it also caused speculation, stagnation and inflation. In order to avoid massive unemployment, the Minister of Economy gradually controlled inflation at the cost of the workers’ wages that lost purchasing power. According to a survey by the Latin America Regional Report: Southern Cone, poverty rose from 7 to 28 percent from 1970 to 1980.

The economy minister that replaced Martinez de Hoz established a single rate for foreign exchange and allowed the peso to float. Again, austerity measures appeared to be the only answer to the spiralling economy – spending was reduced, public wages, pensions and subsidies were frozen and the personal income tax was restricted.

Economic Policy failures

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The burden of international loans that were flowing into the country in 1976-79 became too heavy to bear by 1980. At the end of the military regime the country faced a 400-percent inflation rate, strongly depleted international reserves and a public foreign debt of US$45 billion, which exceeded the country’s annual exports five times.3

When oil prices rose for the second time in 1979, the US Federal Reserve Bank adopted a tight monetary policy which pushed up real interest rates to historically high levels. With the change in the financial situation and US fiscal policies in 1979, Argentina, like many other countries, found itself in a different situation compared to the previous years because the changing levels of debt had now become a crisis. For debtor countries, this not only made new borrowing more expensive, but also increased the amount of interest they had to pay on their old loans, since much of this commercial and financial borrowing was originally contracted with floating interest rates.4 Rates grew from 5.64 percent in 1977 to 16.77 percent in 1981, making the debt burden and the servicing of interests unsustainable.5

Argentina’s access to external financing led to rising fiscal deficits, which then made public-sector accounts highly vulnerable to any tightening of external credit, which eventually did, in fact, occur.

Private Argentine companies also accrued a sizable foreign debt for which the State issued guarantees. When the private companies could not repay their debts, the military government assumed these debts through different mechanisms, thus turning them into public debt in 1982.6 This further increased the already large public foreign debt of the Argentine public sector.7

Overall, the policies of the regime were a reflection of their incoherence: The mix of trade liberalization and unrestrained spending turned out to be an explosive mix in a society with a non-competitive manufacturing sector and a highly organized and mobilized working class.8

The return to democracy: Alfonsín in 1983 to 1989

When Raúl Alfonsín took office in December 1983, there was great hope in the country that he would put a stop to the military regime’s destruction of the national economy. He faced the triple threat of coping with mounting external debt arrears, confronting military upheavals related to human rights violations and responding to the demands of a population that had just achieved political freedom.

The new civilian regime initially implemented a series of limited changes: wage increases, health and housing programs, price controls, tax reforms, and import and exchange controls. However, these policies failed to achieve their targets. Spiralling inflation, continuous price increases and tax evasion, the dominance of speculative financial capital in new productive investments, a lack of dynamic industrial growth, and a rising foreign debt forced the administration to shift its priorities: a subordination of domestic to foreign commitments.

In 1985, Alfonsin implemented a stabilization plan, with some heterodox features. It included wage and price controls, cuts in public expenditure, and a more rigid monetary policy. Later, bowing to the IMF and private foreign banks’ pressures, the administration intensified its austerity program. While real wage levels continued their downward spiral, massive cutbacks in state spending not only had negative effects on social services (health, education, sanitation) and many public works in infrastructure were left unfinished.
Debt interest payments heavily debilitated the economy. Between 1983 and 1988, Argentina was a net exporter of capital: US$28 billion left the country in the form of principal and interest payments while less than US$16 billion in new loans flowed into the economy. At the same time, the total foreign debt jumped from US$46 billion to just over US$60 billion. In 1987, interest payments accounted for an astronomical 56 percent of the country’s export earnings. Over the same period, workers’ purchasing power fell by almost a third. In the run-up to the mid-term elections, the country confronted an almost unbroken succession of wage-related strikes by public sector workers.

Argentina needed to make transfers to the government so that the country could service the external debt and pay the costs of the collapse of the domestic financial system. These transfers could be made more easily in countries where the State had direct access to hard-currency export earnings (mainly through State-owned oil and mineral enterprises) and where the government consequently benefited directly from the devaluations. Others, like Argentina, were confronted with a serious “domestic transfer problem” as they struggled to find ways to transfer fiscal resources to the State to service the public debt; as such services rose in terms of the local currency because of the devaluations, it became even more difficult to cover.  

Throughout the 1980s the Argentine economy showed its worst performance. Investment and savings collapsed. Per capita GDP decreased approximately 20 percent between 1980 and 1989. Inflation was above 100 percent every year except 1986. The dollarization of the economy deepened, increasing the financial fragility of the economy. Finally, with maxi-devaluations and disproportionate increases in public prices, the high inflation regime moved towards hyperinflation.

Stabilization was imperative. When a society has reached such an extreme, the alternatives become stark and difficult to implement.

**References**


2. Latin America Regional Report: Southern Cone, 1 February 1985

3. Rapoport (2000) at 905


5. Buckley (2001) at 22-23


7. See Schvarzer (ibid)

The Case of Brazil and the Trajectory of its Foreign Debt
by Guilherme Daltrozzo Corte

A brief political context

In 1960, João Goulart was democratically elected vice-president of Brazil. One year later, he took over the presidency following the resignation of Janio Quadros. João Goulart had a deep connection with the working class and strongly promoted policies favouring labour rights. In 1964, Brazil experienced a US supported coup d’état and the military took power. From 1964 to 1985, a dictatorship ruled Brazil.

The origins of Brazil’s foreign debt crisis of the 1980s

Prior to the 1980s crisis, there were different phases in the Brazil’s indebtedness process. Initially, from 1968 to 1973, the country’s dictatorship accepted loans from US and European banks in order to foster economic development. The State-led “Import Substitution Industrialization” (ISI) promoted the replacement of foreign imports for domestic production. Funds were also used for infrastructure and large urban projects. A second stage ran from 1974 to 1979. The government intensified its borrowing in an attempt to maintain a high rate of growth despite the new context imposed by the oil crisis and its impact on the Brazilian economy. Finally, after 1979, when the US Federal Reserve sharply increased the interest rate, Brazil had to expand its borrowing due to the increase in the interest payments originated in previous loans.

The early 1980s

As was stated above, Brazil (and other highly indebted countries) faced huge increases in the foreign debt services. Brazil reacted to the new context by increasing its indebtedness in order to pay interests, as well as to maintain the economy’s liquidity.

However, that strategy turned unfeasible after Mexico’s 1982 moratorium. Such default rationed Latin American countries from the voluntary financial markets. In this new scenario, Brazil was forced to produce a highly positive trade balance and an abrupt adjustment in its economic policy for the purpose of obtaining hard currency to repay the debt. Therefore, from 1982 onwards Brazil implemented economic policies that repressed imports and provided export incentives. Some of

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12 Student from the Latin American Programme on Human Rights and Democratization.
the investment projects established in the 1960s and 1970s had already matured, and Brazil had an increasing production of industrial commodities to complement primary (mineral and agricultural) exports.

As export revenues belonged to the private sector (and not to the indebted public sector), Brazil faced a “domestic transfer problem”. The public sector needed to buy hard currency from exporters, which was done through a combination of money creation and the selling of bonds in the domestic financial system. With these operations, Brazil attempted to partially swap its foreign debt, but it resulted in growing inflation, recession and unemployment. Record inflation rates were also registered towards the final years of the decade, resulting in a further impoverishment of its population. Finally, the Brady Plan allowed the Latin American countries to restructure their debts and obtain new loans from the international financial system.

**Conclusion**

Although Brazil had a more controlled foreign indebtedness process than other Latin American countries (and channelled more funds into public investment projects that later produced positive results), a large part of the population did not benefit from it. To the contrary, when the crisis finally imploded, the most vulnerable sectors of the society were the ones that suffered the most. In light of the above, it is essential that civil society takes a more active role in ensuring that the request of foreign loans for development is subject to safeguards in order to ensure transparency and accountability.
Chile’s Foreign Debt
by Lenin Miranda Maldonado

In order to explain the process of the external debt in Latin America, it is important to explain not just the economic context, but also the political background. At the beginning of 1970, Salvador Allende was the first socialist president in Latin America who came to power through open elections in Chile. In September 1973, General Augusto Pinochet led a coup d’état and established a military ruling which lasted almost 17 years. During that period, civil and political rights were violated and around 3,000 people disappeared. Social, economic and cultural rights were also disrupted. Chile’s debt and financial crisis, which is the focus of this chapter, took place in the middle of this Military Dictatorship.

How did it happen? How could a small Latin American economy accumulate a debt of more than US$20 billion in such a brief period? The origin of the problem can be traced to Chile’s sudden liberalization of the financial system and the impact it had on the growth of the foreign debt. In the 1970s Chile experienced deep changes in its financial scheme as the country moved away from a repressed financial structure to a liberalized system. Under the new rules, any economic actor (either private or public), could request money in the international markets without any further control.

Starting in 1975, changes in the effective financial restrictions helped to accelerate the borrowing demand. Initially, foreign debt grew slowly between 1975 and 1977. But the growth rate jumped one year later after the financial system as a whole was liberalized. In 1981, the period of the "private boom credit", Chile’s total foreign debt reached almost US$16 billion. It increased almost US$11 billion in four years. In other words, the relaxation of financial restrictions, at a time when international loans were abundant, is directly related to the behavior of Chile’s foreign debt.

Also important is the role of the private sector. Once the financial system had been liberalized, private actors played an important role in the growth of the foreign debt. A large share of Chile’s total foreign debt originated in the private sector, basically from private banks. In 1981, 65 percent of the total debt was private. This was a common scenario that occurred not just in Chile, but across the region. The restrictions on credits were gradually lifted, and at some point they practically disappeared. The private sector took advantage of the capital account liberalization and the liquidity of international markets.

Private borrowing, mainly created by banks, was carried out through commercial banks, which intermediated between the international financial centers and the country’s economy. Before that, at the beginning of the military government (1973-77), Chilean banks’ access to external credit was limited to the financing of foreign trade. Note that between 1979 and 1981, the interest rates...
for foreign loans were extremely high as a consequence of the rise in international interest rates determined by the US Federal Reserve. In conclusion, the combination of the large international credit supply and local private demand led Chile into one of the most complicated economic crises in its history.

In 1982 Mexico was the first country in the region to declare that it could no longer repay the foreign debt. The international capital market reacted immediately by cutting any credit to that region. As a consequence, during the 1980s, Chile experienced one of the most serious economic crises in its history. In that regard, from 1966 - 1970 the unemployment rate was at 5 percent but in the period 1975-82 that number reached almost 18 percent. In sum, the entire economy was troubled. The price of copper in the international market was also very low and this affected Chile’s GDP, which was strongly connected with the price of this commodity.

Finally, how could Chile recover from this crisis? First, unlike other Latin American countries, Chile obtained more support from the IMF and the World Bank in the form of credits with very low interest rates in order to cover its payment gaps. However, and most important, Chile –still under a military regime – received more help from international financial institutions in order to pay its foreign debt than other countries undergoing a democratic transition. Second is the price of refined copper. After 1983 the price of this commodity went up. Copper was Chile’s main export, and the country benefited from a more rapid recovery of its terms of trade than others. Finally, it managed to swap a portion of its debt in secondary markets at a large discount.

**Mexico in the 1980s**

by Ana I. Mata

During the 1970s, Mexico obtained low interest credits from different US and European banks. Mexico, as an oil exporter, was in a rather favourable position: the 1973 oil crisis had restricted oil production in the Middle East, suddenly raising prices for the existing demand.

Between 1976 and 1982, the Mexican administration was headed by President López Portillo. He was a member of the Institutional Revolutionary Party (PRI), which governed Mexico successively from 1946. There was no political alternance and Mexican democracy was relatively weak. Nonetheless, Mexico was one of the few countries in the Latin American region that did not fall under a military dictatorship during the 1970s.

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13 Student from the Latin American Programme on Human Rights and Democratization.
14 Change of power began in 2000, after 72 years of rule by the PRI.
López Portillo introduced policies that made the economy and commerce rely almost entirely on petrol. In fact, between 1972 and 1982, production levels of crude oil increased nearly ten times.\textsuperscript{15} It was during the 1980s, specifically in 1982 that 82 percent of all exports were, in fact, crude oil.\textsuperscript{16} Many authors criticized the “petrolization” of the economy; they said that such dependence on a single commodity was short sighted, as well as risky. However, Mexico grew while oil prices were still high. Financial shortcuts were resolved with debt. This gave way to a new phase in the history of the Mexican debt: the petrol debt.

The international context changed in 1979, after the US Federal Reserve applied a restrictive monetary policy that sharply increased the interest rates (in dollars) worldwide. Interests on the Mexican international debt made the debt harder to service. New credits were taken out to try to cover the interest rates on debt. When the price of petrol dropped in 1982, the situation became unsustainable. The cycle of high oil prices had lasted for almost ten years and yet Mexico had not developed a mechanism to deal with a price drop. Mexico declared a unilateral moratorium on its debt, and started long and complicated negotiations with creditor banks that lasted until 1989, when the Brady Plan was finally implemented.

Low oil prices prevailed throughout that period. In 1985, the price of oil was US$25.33 per barrel. The average price plummeted in the following years. In 1986 and 1987, for example, it reached a record-low price of US$11.86 per barrel.\textsuperscript{17} The financial dependence on oil revenues was made particularly visible during those years. Adjustment policies encompassed two significant measures: 1) income contraction and 2) subsidy withdrawals. So, adjustment policies affected income levels and were accompanied by a larger, unequal income distribution.\textsuperscript{18} That is, redistribution benefited those who collected incomes other than salaries.

Employment was harshly affected by the adjustment measures adopted during the 1980s. Employment growth was stalled and there was a dramatic drop in real salaries. This gave way to the descent of the minimum wage and an even greater drop in the average wage. That is, when the minimum wage dropped a real average percentage of -22.0 in 1984, the average income dropped to -24.8.\textsuperscript{19} Also, a large amount of rural workers, who had moved into cities seeking jobs and found no opportunity to better their living conditions, became part of a marginal, underemployed urban population. More than 50 percent of the economically active population working in urban areas in 1987 did not even earn the legal minimum wage and they worked without any benefits whatsoever.

Money that was previously spent on goods and services was then used to buy the most basic subsistence goods. But due to the drop suffered by the minimum and average wages, the consumption of the most basic components of the Mexican diet was difficult. Some 40 percent of the poorest Mexicans spent 63.2 percent of their family’s income on food, a proportion that tended to grow, together with the rise in prices and the withdrawal of subsidies.\textsuperscript{20}

\textsuperscript{15} Available at: http://www.inegi.org.mx/prod_serv/contenidos/espanol/bvinegi/productos/integracion/pais/historicas10/Tema10_Sector_energetico.pdf
\textsuperscript{17} Idem
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\textsuperscript{19} Idem
\textsuperscript{20} Idem
This decade was also characterized by a rise in the demand for public health services. This could be partly attributed to the population’s inadequate nutrition. Carbohydrates replaced proteins; consumption of the basic dietary components fell and daily meals were suppressed becoming a common feature.

During the rest of the decade basic goods became unavailable for the general population. In fact, 50 percent of all agricultural products were consumed by only 15 percent of the population. Wider deficiencies developed owing to the lack of protein consumption, descending from 26.3 percent per capita in 1982, to 11.8 percent in 1985. According to the National Health Program, the most marginal groups reduced their caloric intake by 18 percent, between 1982 and 1985, vegetable protein sources by 15 percent and animal protein sources by 50 percent in three years. This scenario resulted in an overall state of malnutrition that provoked a severe turning point in the population’s mortality and morbidity rates.

In 1984 the number of deaths every 10,000 people increased for the first time in years, from 5.22 in 1983 to 5.39 in 1986. And child mortality registered a marked increase in deaths attributed to vitamin A deficiency, as well as other nutritional deficiencies.

Giving preference to nutrition had other consequences. For example, the beneficiaries of the several social security institutions - between 1981 and 1986 - made more use of outpatient services than in the past. This larger demand for such services did not lead to better and wider services. Instead, the same supply was used more intensively, producing a significant decline in the quality of the services.

As to education, attention to global demand went from 71.4 percent in 1983 to 69.3 percent in 1986. The secondary school education system captured 87 percent of the children who had graduated from primary school in 1982, but only 82.1 percent in 1984. There was a considerable reduction in private secondary school enrolment and the participation in public secondary schools increased from 84.4 percent in 1982 to 90.6 percent in 1985. Finally, the demand for open secondary programs went up to 80 percent between 1982 and 1986.

This configures the educational setting during the 1980’s crisis. There was either an initiative to take advantage of all the educational public services or an initiative to drop out.

So, in sum, employment, health and education were widely affected during the 1980’s debt crisis in Mexico. Note that just two years ago, in 2013, at the Thematic Discussion on Inequality that the General Assembly of the United Nations organized, the comments touched precisely on these points: employment and education may be two of the three main points to tackle inequality.

According to researcher Carlos Marichal, paying the debt is detrimental to human rights. The Mexican government today allocates 2.5 times more money to service the debt than it does on education in a country where half the population lives in poverty. In 2000, two decades after the crisis, Mexico has paid the equivalent of eight times its initial 1982 debt in interests alone, the sum of US$162 billion.

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21 Available at: http://www.latinamerica.undp.org/content/rblac/en/home/presscenter/speeches/2013/07/10/lessons-from-the-world-s-most-unequal-region.html
It has become increasingly clear that we are witnessing a paradox in which states ask for money to achieve development and, at the same time, it is that very money that keeps the states from achieving development.