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## The New Latin American Debt Crisis and Its Implications for Managing Financial and Social Risk

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### EXECUTIVE SUMMARY

The potential for sovereign default in Latin America has become a very real possibility. This was driven home by Argentina's recent sovereign debt crisis, which represented the largest default in history. The Argentine case suggests that the current market-based approach of sovereign debt management is not conducive to dealing effectively with the social risks associated with financial crisis. The existing informal and *ad hoc* international architecture of sovereign debt management serves to place the interests of transnational financial actors over those who must face the brunt of the crisis – which includes the poor who now account for over 50 percent of the Argentine population. It also acts to restrict policy formulation in such a manner as to create a legitimacy deficit for crisis-hit governments, which, in turn, could have destabilizing effects, such as a further deterioration of a country's creditworthiness due to political unrest.

A formalised structure of governance mechanisms to manage sovereign bankruptcy offers three potential benefits. Firstly, the potential for governments to petition pre-emptively for a hold on debt repayments could prevent a crisis situation from escalating, therein avoiding financial meltdown situations and the inherent social dislocation involved. Secondly, a formalised system of adjudication could avoid deadlocked negotiations between sovereign and creditors, as is currently occurring in the Argentinean debacle. Thirdly, a process that recognises the social rights of the debtor-country population – and that gives civil society groups a voice in the proceedings – would enable a repayment schedule to be constructed that does not sacrifice public expenditures for social protection on the altar of creditor repayment. This paper reviews three sovereign debt governance mechanisms put forward in the wake of the Argentine crisis, although it cautions that a preferable solution must involve examining the root causes of sovereign default in the current era.

### RÉSUMÉ

Le potentiel de défaut souverain en Amérique latine est devenu une véritable possibilité. Cette situation a été introduite par la récente crise de la dette nationale de l'Argentine, qui est devenue le pire cas de défaut souverain de l'histoire. Le cas de l'Argentine suggère que la gestion de la dette souveraine n'est guère favorisée par une



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approche de marché économique qui ne traite pas efficacement les risques sociaux liés à la crise financière. L'architecture internationale informelle et *ad hoc* qui existe au niveau de la gestion de dette souveraine sert à placer les intérêts des acteurs transnationaux au-dessus de ceux qui devront subir les conséquences réelles de la crise - ce qui inclut les pauvres qui représentent maintenant plus de 50 pour cent de la population de l'Argentine. Ce système sert également à limiter la formulation des politiques d'une manière qui occasionne un déficit de légitimité pour les gouvernements frappés par une crise, qui, alternativement, pourraient avoir des effets de déstabilisation comme la détérioration de la solvabilité d'un pays due à l'instabilité politique.

Une structure formalisée des mécanismes gouvernementaux pour gérer la faillite souveraine offre trois avantages potentiels. Premièrement, le potentiel de préemption pour une retenue sur les remboursements de dette pour les gouvernements pourrait empêcher une situation de crise d'escalader, évitant ainsi l'effondrement du système financier et la dislocation sociale inhérente impliquée. Deuxièmement, un système formalisé d'adjudication pourrait éviter des négociations menant à l'impasse entre souverain et créanciers, comme dans le cas de la débâcle argentine qui se poursuit actuellement. Troisièmement, un processus qui reconnaît les droits sociaux de la population du pays débiteur — et ceci accorderait une voix aux groupes de la société civile de se faire entendre dans les démarches— permettrait la réalisation d'un programme de remboursement qui ne sacrifiera pas des dépenses publiques pour la protection sociale sur l'autel du remboursement des créanciers. Cet article passe en revue trois mécanismes gouvernementaux de gestion de la dette souveraine proposés à la suite de la crise de l'Argentine, bien qu'il avertisse qu'une solution préférable devrait impliquer un examen des causes du défaut souverain dans l'ère courante.

## RESUMEN

La perspectiva de la incapacidad de los estados en América Latina de cumplir con el servicio de sus deudas (*default*) es una posibilidad real. Lo anterior quedó puesto de relieve por la reciente crisis estatal argentina, la cual significó la mayor crisis por incumplimiento de la historia. El caso de Argentina nos muestra que el actual procedimiento basado en el mercado para manejar las deudas gubernamentales no ayuda a resolver de manera eficaz los peligros sociales asociados a las crisis financieras. El esquema informal y ad hoc internacional que existe para resolver las deudas estatales coloca los intereses de los agentes financieros internacionales por encima de aquellos que deben cargar con el mayor peso de la crisis: los pobres que representan más del 50% de la población argentina. Asimismo, restringe la formulación de políticas de tal manera que le resta legitimidad a los estados afectados por la crisis, lo que a su vez podría acarrear efectos desestabilizadores tales como un mayor deterioro de la capacidad del país para obtener concesiones crediticias debido a la inestabilidad política.

La puesta en funcionamiento de un esquema formalizado de mecanismos para enfrentar la quiebra estatal ofrecería tres beneficios. Primero, la posibilidad de que los gobiernos puedan solicitar preventivamente un aplazamiento de los pagos de la deuda, ayudaría a evitar el descalabro financiero y la escalada de la crisis y sus trastornos sociales inherentes. Segundo, la instauración de un mecanismo de arbitraje podría ayudar a evitar el estancamiento de las negociaciones entre los estados y sus acreedores, como está ocurriendo en la tragedia argentina. Tercero, el establecimiento de un proceso que reconozca los derechos sociales de la población del país deudor, y que le otorgue un espacio a los grupos de la sociedad civil en la mesa de negociaciones, facilitaría la elaboración de un programa para el servicio de la deuda que no sacrifique los gastos públicos de protección social por satisfacer las obligaciones de pago. Este trabajo analiza tres mecanismos diferentes para manejar las deudas estatales, presentados a raíz de la crisis argentina, aunque se advierte que una solución óptima debe partir del análisis de las causas que dieron origen a la cesación de pagos de determinado estado.

## INTRODUCTION

Following the litany of financial crises that struck developing countries during the 1990s, there has been a growing recognition that global capital markets are subject to pronounced instability. In times of boom, they can offer significant financial resources to both public and private sectors in developing countries. At times of bust, however, mass capital flight results in extensive economic and social disruption and escalates pressure on public debt burdens. This raises an important question: given the inherent instability of financial flows, what is the relationship between the financial risk assumed by borrowing governments, and the social risk implicit in the threat of financial crisis? And when a financial crisis erupts, what governance mechanisms can be implemented to ensure that not just the property rights of investors are respected, but also the human and social rights of affected populations?

The current crisis in Argentina has brought these questions to the fore. Although successive Argentine governments since 1990 had been commended for their adoption of International Monetary Fund (IMF)-sponsored economic reforms; the experience of economic stagnation, an expanding debt burden and an over-reliance on short-term capital flows set the stage for a dramatic crisis in the new millennium. Subsequently, the financial meltdown in December 2001 has left an insolvent government in tense negotiations with the IMF and private creditors whilst simultaneously attempting to mediate the devastating social effects of the crisis. Competing claims upon scarce fiscal resources have set the tone for recent conflicts between the Argentine government, the IMF, creditor groups and the Argentine population. With no formalised mechanism for resolving these conflicts, and with no official forum for civil society groups to have a voice in the proceedings, the Argentine situation remains precarious.

To this end the paper explores three policy options for managing debt crises in emerging markets. The discussion begins with the IMF's 2001 proposal for dealing with sovereign debt: the Sovereign Debt Restructuring Mechanism (SDRM). By permitting a crisis-hit country to come to the IMF and request a

temporary standstill on the repayment of its debts, this proposal was intended to create time for governments to negotiate a restructuring with creditors. The overall aim, therefore, was to avoid the sudden panics and mass-capital outflows that may otherwise occur and that unleash destructive social consequences upon the crisis-stricken country.

The second proposal examined in the paper concerns the implementation of a statutory-based mechanism to deal with sovereign debt defaults, namely: collection action clauses (CACs). CACs are a decentralized, market-based strategy that allows a supermajority of bondholders to approve a process. This is believed to make it easier to restructure debt because it allows a majority of creditors to negotiate a generalized deal with the sovereign state. However, the proposal is concerned solely with managing post-insolvency situations. It does not recognise the need to examine social risk as an essential dimension of sovereign bankruptcy proceedings, nor does it provide for a transparent process in which civil society groups are able to formally voice concerns.

This leads the paper to analyse a third proposal for mediating the threat of sovereign insolvency. Modelled upon the United States Chapter 9 bankruptcy law, this final proposal is the only one that explicitly notes the need for a more transparent and democratic manner of managing sovereign insolvency proceedings. By acknowledging that sovereign default is a very different phenomenon from default in the private sector, owing to the obligations of the state to provide services to its population, Chapter 9-style models of sovereign default proceedings offer a potentially more satisfactory manner of reconciling the financial risks of creditors with the social risks incurred by the debtor-country. Repeated failures in the current informal negotiations over Argentina's default give urgency to the need to establish a formalised sovereign bankruptcy procedure that can adequately address these tensions.

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## DEBT IN A GLOBALIZING WORLD

Alongside the trend toward economic liberalisation that was promoted by the IMF and World Bank in the wake of the Debt Crisis of the early 1980s, there has also been a shift towards deregulating the move-

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*Despite the commonly held assumption that the Latin American Debt Crisis ended in the 1980s, Latin American countries remain heavily indebted and must constantly acquire new debts to cover interest and repayments on the old...*

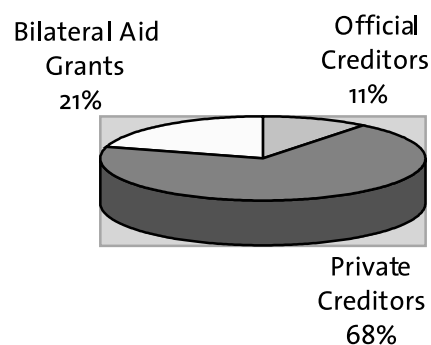
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ment of capital across borders. The IMF suggests that free capital mobility, just like free trade, is universally desirable on the grounds of shared efficiency gains and, therefore, has consistently advocated that developing countries deregulate their capital accounts. On this basis, countries have increasingly liberalised their capital accounts, therein removing restrictions to the inflow and outflow of capital. As a consequence, financial flows have undergone at least two inter-linked changes since the mid-1980s that have had enormous consequences for governments of the South. First, official development finance, especially its previously largest component, bilateral aid, has lagged behind private flows. Indeed, over two-thirds of all lending to developing world governments is private lending from international banks and other private institutional investors.

Second, the composition of these private credit flows to middle-income public sectors has been marked by a notable increase in short-term loans and securitized debt. This short-term public borrowing parallels the growing importance of portfolio investment for the private sector. Portfolio investment, which is composed of largely short-term investment in financial assets such as stocks, can be contrasted to foreign direct investment (FDI), which is a more stable form of investment directed primarily at facilitating productive activities on the ground. Similarly, short-term securitized public debt can in turn be contrasted to traditional bank lending that is generally longer-term.

The upsurge in short-term lending occurred most pronouncedly in the early and mid-1990s when low interest rates in the US encouraged capital movement to the South. For instance, by 1993, 74 per cent of private foreign investment in Argentina, Brazil,

**Figure 1: Financial Flows to the South (1997)**



Total Inflow US\$102.1 billion

Source: World Bank 2003.

Chile, Mexico and Sri Lanka was portfolio capital coming from mutual funds and pension funds. As the Executive Secretary of the UN Economic Commission for Latin America and the Caribbean, José Antonio Ocampo noted, the emerging markets (or, middle-income countries) began to receive a high concentration of the most volatile type of capital flows (Ocampo 2000).

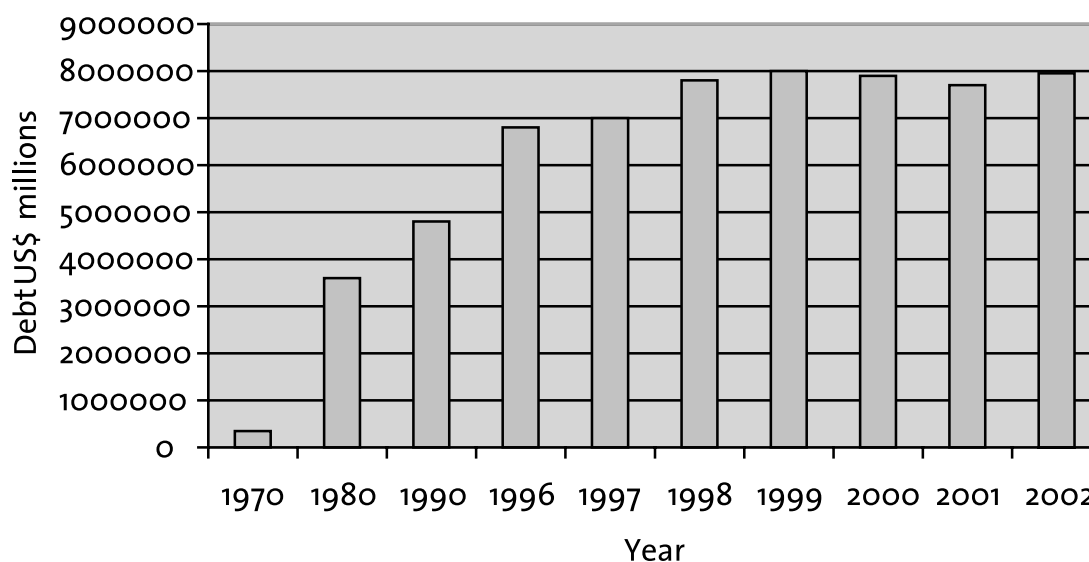
Although the financial crises in Mexico, East Asia, Brazil, Russia and Argentina indicated the risks inherent to global capital markets, emerging market economies in Latin America nonetheless retain a strong reliance on such private, short-term capital inflows. For the private sector, such flows offer access to capital that can be used for productive restructuring in a climate of fierce global competition. Concurrently, governments have drawn repeatedly on short-term capital to roll over long-term public debt. Despite the commonly held assumption that

### International Investment Instruments

Financial Instrument	Investor	Recipient of funds	Volatility
Foreign aid	Public	Public sector	Low
Foreign Direct Investment	Private	Private sector	Low
Bank loans to government	Private	Public sector	Medium
Bank loans to private firms	Private	Private sector	Medium
Portfolio investments with government	Private	Public sector	High
Portfolio investments in private firms	Private	Private sector	High

Source: Armijo 1999.

**Figure 2: Latin America and the Caribbean – Balance of Foreign Debt**



Source: The Economic Commission for Latin America and the Caribbean (CEPAL), 2003.

the Latin American Debt Crisis ended in the 1980s, Latin American countries remain heavily indebted and must constantly acquire new debts to cover interest and repayments on the old.

Whilst the Asian financial crisis of 1997-8 created a generalized distrust of investing in the developing world, in which the dramatic rise in short-term capital movements to the South turned into negative flows, this appears likely to be a temporary pause. Owing to low interest rates in the recession-hit advanced industrialised world, institutional investors are, once again, taking advantage of the relatively higher rates in emerging markets by extending credit in the form of securities and bonds. For example, the Institute of International Finance (IIF) reported in 2004 that net private capital flows to emerging market economies rose sharply in 2003 to \$187 billion from just \$124 billion in 2002, an increase of 50 per cent. The IIF forecasts robust 2004 flows that are expected to rise to approximately \$196 billion ([www.iif.com](http://www.iif.com)).

These changes regarding the nature of capital flows to emerging market economies, and subsequent debt trends, have had important political ramifications for governments, or what can be referred to as a *policy paradox* for middle-income developing countries (Soederberg, 2004). Two mutually reinforcing effects that financial flows have on national policy formation in the emerging markets are addressed below: (1) the creation of greater vulnerability to

financial volatility and crisis owing to the short-term and relatively mobile nature of these flows; and (2) the resulting imposition of constraints on policy autonomy, not only in terms of macro-economic policy but also social policy formation (Gabel 1996).

#### **SHORT-TERM CAPITAL AND POLICY CONSTRAINTS**

To attract and retain private capital flows coming from private financial institutions such as mutual funds, hedge funds and pension funds, states are continually required to demonstrate creditworthiness. Although what counts as creditworthiness necessarily relies on many contingent factors, it is commonly understood to involve ensuring sound economic fundamentals (including balanced budgets, stable currency and interest rates) whilst cultivating an investor-friendly environment, such as permitting unhindered profit remittances, maintaining open capital accounts, low taxation burdens, and political stability. As a result, the IMF and World Bank suggest that the discipline entailed in signalling creditworthiness represents a positive imposition on countries, with private capital rewarding good policies and suitable political climates.

Other analysts, however, have suggested that appeasing the desires of financial investors can take precedence over sound policy making. The shift in lending patterns involved in development finance has meant that new, diverse yet powerful sets of actors play an increasingly important role in affect-

ing policy formation at the national level. The threat of rapid short-term capital outflow constrains policy making on a number of issues, including inflation containment and exchange rate policy, not to mention a more general commitment to neoliberal-style policy.

Moreover, if internal or external factors threaten to create an outflow of short-term capital, governments frequently make policy decisions aimed at appeasing investors despite the potential long-term irrationality of these choices. For example, the decision of the Mexican government in 1993 to convert its sovereign bond release from denomination in pesos (*cetes*) to dollars (*tesobonos*) was designed to restore investor confidence in Mexico. However, the medium-term result was to leave the country's taxpayers with an immense burden when the peso depreciated at the outset of the 1994/5 Peso Crisis.

A fundamental question, and one which is brought most sharply to the fore at moments of crisis, is whether debtor states become potentially more accountable to transnational capitals than to those whom they govern. Some observers have referred to this discrepancy as a legitimacy deficit (Underhill, 1997). These potential tensions become most visible at times of crisis, where the claims of financial investors must be weighed against those of a population wracked by economic dislocation.

Owing to such considerations, observers across the political spectrum have criticized the IMF's resolute defence of the rationality of capital account liberalisation. It is extremely questionable whether short-term capital flows are closely connected to underlying economic fundamentals. The vast scale of the East Asian crisis in 1997-8, for example, was divorced from conditions in the real economy. Equally, despite manifold structural problems in both Mexico in 1994/5 and Argentina in 2000, investors continued to be attracted to these countries. Perversely, the very existence of high interest rates that signified an elevated degree of financial risk, also served to attract investors looking to exploit differentials between established markets and the emerging economies – a technique known as arbitrage (Rodrik, 2003). Unfortunately, however, the social risk entailed in the actualisation of crisis falls not upon the investors but upon the populations of developing countries.

## FINANCIAL RISK AND SOCIAL RISK

As witnessed throughout the 1990s and beyond, financial crises can unleash devastating effects upon the social fabric of developing countries. Two immediate effects can be discerned. First, a sharp outflow of short-term capital tends to precipitate panic amongst other investors who follow suit, thereby causing asset devaluation and bankruptcies in the host country. The effects upon the productive economy are profound: a rash of bankruptcies ejects workers into the ranks of the unemployed and precipitates generalized wage cuts, thereby escalating social deprivation and poverty. Whilst noting the heterogeneous impact of crises in particular countries, the World Bank highlighted that: "the negative social impact of the East Asian crisis and consequent crises in Russia and Brazil has been enormous. The increase in consumption poverty has been significant. In addition, the crisis has resulted in large and costly re-allocations of people and sharp declines in middle-class standards of living" (World Bank 2000: 47).

At the same time as financial crises cause intense socio-economic disruption, they necessarily impact strongly on public accounts in a context of overall declining revenue. Intense pressure is placed upon governments to reduce public expenditures in order to generate revenue with which to pay back creditors and to shore up the stricken financial system. This implies that tax revenues increasingly go to pay foreign creditors rather than being used for public expenditure on health, education or anti-poverty programmes. Government social expenditure is profoundly restricted at the same time that a widespread state intervention appears necessary in order to compensate for the devastating social impact of the crisis. Financial crises thereby appear to open up a fundamental tension between the property rights of investors and the social rights of afflicted populations. This unfortunate situation is well profiled in the recent Argentine meltdown.

## FINANCIAL AND SOCIAL RISK IN THE ARGENTINEAN CRISIS

Argentina is widely recognised to have worked closely with the IMF in designing its post-1990 neoliberal-style economic restructuring strategies, which the IMF supported with significant loan disbursements throughout the 1990s. These policies emerged as a

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desperate attempt to save a collapsing economy that experienced monthly inflation rates of 200 percent in 1989. The then president Carlos Menem sought to implement what he referred to as a 'shock of hyper credibility' through strict adherence to World Bank and IMF policies. Owing to the limited success of these measures in the first two years, Finance Minister Domingo Cavallo subsequently devised what would become the backbone of Menem's 'shock of hypercredibility', namely: a currency-convertibility (currency board) system that became law in early 1991. This measure entailed the adoption of a currency guaranteed to be convertible at one-to-one rate to the US dollar.

Apart from ending hyper-inflation, Cavallo argued that convertibility would encourage domestic savings, owing to the stability of the peso's value in US dollars, and would attract foreign investment and Argentine funds from abroad, as holding money in Argentina would be as safe as keeping it in the United States. Further, the convertibility program was intended to initiate a durable credit system, enabling higher consumer spending to boost housing and manufacturing. Critics of the convertibility plan were quick to point out the dangers of guaranteeing peso-dollar equivalence. When the dollar appreciated against other currencies, Argentine exports would become less competitive; particularly as only 10 percent of these went to the US. Cavallo also failed to account for the effects of US interest rates, whose stability at low levels were a significant precondition for the success of the peso-dollar peg.

The apparent 'miracle transition' occurred in 1991, when recession in the United States pushed funds outwards towards emerging markets. With low interest rates in the US, the foreign capital needed for structural adjustment reforms in Argentina flooded in. During the early 1990s, Argentina became the fourth largest recipient of foreign funds throughout the world. The capital influx climbed from \$3.2 billion in 1991 to \$10.7 billion in 1993. US interest rates remained low until late 1994 – precisely demarcating the duration of the Menem boom. However, between February 1994 and January 1995 the Federal Reserve Board implemented a series of interest rate hikes that doubled US short-term rates (from 3 to 6 percent). The cost of the Argentine gov-

ernment's borrowing, much of it used purely to roll-over past debt, increased by both the Federal Reserve's 3 percentage points, as well as the increasing spread between Argentine government bonds and US Treasuries of the same maturity (Rock, 2002).

Notably, a significant portion of this sovereign debt – which currently bedevils the Argentine population owing to colossal interest repayments – is of dubious political origins. Close to twenty percent relates to loans made during the dictatorship period, in which there was no democratic accountability and high levels of corruption. Secondly, in the aftermath of the 1982 debt crisis further amounts of private debt – estimated to be in the region of US\$1.4 billion – were nationalised in order to bail out the over-extended financial sector. Again, there was no public oversight of these transactions and much of the official documentation was destroyed when the authoritarian regime collapsed (Pettifor *et al.*, 2001).

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The Argentine economic situation worsened drastically with the devaluation of the Mexican peso in December of 1994. Within weeks, the Argentine banking system lost 18 percent of its deposits and the economy plunged into recession. Incipient recovery began in late 1996 when both public and private capital inflows resumed, encouraged by the Argentine government's commitment to the currency board. However the Asian financial crisis dramatically raised Argentina's risk premium and cost of borrowing. The overvalued peso further undermined confidence in the exchange

rate regime and led to a deteriorating current account. Concurrently, the spread of financial crisis to Brazil in 1998 had devastating effects on Argentine's exports.

Owing to several complicated reasons such as political pressure from the country's large middle class who wished to protect the value of their savings, and support from the IMF, the Argentine government refused to allow the peso to fall. There were repeated attempts to restore confidence in the overvalued peso through spending cuts and IMF loans, including a \$40 billion loan package in December of 2000. These strategies, however, proved ineffective in reversing the downward spiral. Rapidly escalating interest payments on the sovereign debt rose from \$2.5 billion in 1991 to \$9.5 billion in 2000, figures that correspond 1.2 to 3.4 percent of GDP respectively

(Weisbrot and Baker, 2002). Moreover, political inefficiencies and corruption within the state manager class further deepened the crisis, incurring greater levels of social dislocation and greater debt (Haslam, 2003).

With the full outbreak of crisis in 2001, poverty levels have soared from around 16 percent of the population in 1999 to over fifty percent in 2002. Of Argentina's population of 37 million, 52 percent – some 19 million people- now fall below the official poverty line, while 20 percent, 7.5 million, exist in conditions of indigence, meaning that they can no longer afford sufficient food to meet nutritional requirements (Rock, 2002).

In accepting IMF credit to help avoid complete bankruptcy, the Argentine government agreed to strictly control its social expenditure and, particularly, the payment of public servants in order to maintain debt interest payments. Indeed, with more than \$100bn currently in default, Argentina accrues \$700 million - about 0.5 percent of gross domestic product - in past due interest every month. This mounting sum has created incredible tension between the financial claims of creditors and the social rights of the Argentine people. Reacting to such contradictions, Argentine President Nestor Kirchner claimed that: "We will not pay if that means an increasing number of Argentines have to go without education, healthcare, housing, a decent job."

For example, in the health sector, the crisis placed a huge fiscal burden on public provision. On the one hand, the growth in poverty and unemployment and the fall in real wages reduced the contributions of workers to their public health funds. Concurrently, the number of people using the public system grew owing to their inability to afford private care. On the other hand, the transfer of public resources came under significant pressure, including late payments and the deterioration of their real value owing to high levels of inflation within the crisis (Fiszbein *et al.*, 2002).

As a response, Argentina has been partially able to keep social programmes running over the last three years through reallocating large loans from the World Bank that have enabled education, health and

anti-poverty systems to avoid fiscal collapse. The significant drawback of this form of maintaining social services, however, is the creation of substantial amounts of new public debt, which raises significant questions over the sustainability of such arrangements. In 2002, for example, the Bank reallocated US\$240 million from previous loans to finance social services such as health, education and community dining halls.

Simultaneous to pressures on social expenditure, the debt restructuring negotiations have bordered on the chaotic. Despite the claims of the Argentine government that in order to make debt repayment sustainable it would need to repay 25 cents on the dollar invested, private-sector creditors have fiercely resisted this offer, describing it as 'barbarous.' The IMF also finds this offer unacceptable. Two elements

can be highlighted that are further hampering the negotiations. Firstly, the Argentine government and the IMF have repeatedly clashed over the disbursement of funds to help mitigate the crisis and to aid the rollover of interest payments whilst restructuring continues.

Secondly, the Argentine government must face a plethora of different financial actors, which makes the process of agreeing to a comprehensive debt-restructuring package exceedingly complex. In the case of Argentina's default such actors include: the Global Committee on Argentine Bondholders (GCAB), representing some 70 major institutional investors; the Argentine Bond Restructuring Agency (ABRA), representing retail investors in countries including

Germany and Austria; Task Force Argentina (TFA), representing Italian bondholders; and the Bank of Tokyo Mitsubishi and Shinsei Bank, jointly representing Japanese holders of Argentine debt. Each individual creditor institution can potentially hold out against a general settlement, hence placing more strain on the informal processes of negotiation. For example, in February 2004 a US judge placed restrictions on the sale of some Argentine military property in the US in the first such ruling in favour of Argentine's private-sector creditors seeking to regain lost investments (*Financial Times*, February 9, 2004).

Unsurprisingly, the debacle of the Argentine crisis and the chaotic manner of debt renegotiation have led to a plethora of calls for reformulating the inter-

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national financial architecture in order to avoid these problems in the future. The paper now turns to examine these proposals.

## THE SOVERIGN DEBT RESTRUCTURING MECHANISM

On the heels of the Argentinean meltdown, the Spring 2002 meetings of the IMF and World Bank in Washington, D.C. were concerned with shoring up the stability of the much-maligned international financial system. Within these discussions, the G-7 finance ministers and the IMF's monetary and finance committee endorsed a two-track approach to improve procedures for dealing with sovereign bankruptcies. The political impetus to create some form of sovereign debt restructuring mechanism (SDRM) was driven primarily by a perceived need to deal more effectively with sovereign debt so as to try and prevent the rapid escalation of financial crises that threatened global contagion. Moreover, the IMF and G-7 policymakers were worried that crisis pressures could induce debtor countries to turn to economic strategies other than neoliberal orthodoxy, potentially closing themselves off from the global economy and international finance.

A third factor that was also important in these negotiations was the activism of non-governmental organisations (NGOs), such as the Jubilee campaigns that lobbied for several years to promote an arbitration mechanism that would fairly and independently determine how debt should be repaid. Indeed, proposals for instituting a framework for managing sovereign defaults in a more controlled and, in theory, less socially-destructive manner had emerged following the *ad hoc* responses to the debt crisis of the early 1980s (Raffer, 1990). These alternative strategies are examined below.

The document that the G-7 ministers received for discussion at the Spring 2002 meeting was a watered down version of an original proposal put forward in November 2001 by the IMF's Deputy Managing Director, Anne Krueger. Broadly, this original proposal (SDRM-1) suggested the need for a 'sovereign debt restructuring mechanism' that would facilitate a new international legal framework based on the features of domestic bankruptcy proceedings in the private sector. Specifically, this proposal sought to

establish provisions for sovereign bankruptcy modelled on the current Chapter 11 bankruptcy proceedings of the US. The idea was to create a binding set of regulations through which crisis-stricken countries could buy time for political leaders to restructure debts in an orderly fashion without the mass panic that had characterized the crises in Mexico (1994), East Asia (1997), Russia and Brazil (1998), and most recently Argentina (2001).

When emerging economic difficulties raise questions about a country's ability to pay back creditors, the rational response of investors is to attempt to solicit rapid repayment of their investment whilst the debtor country still retains the funds to do so. The cumulative result of each individual creditor demanding immediate payment to avert future difficulties, however, is precisely to create the crisis that

they fear. In short, the herd-like behaviour of financial investors can induce a self-fulfilling crisis that reduces the likelihood of an orderly repayment by plunging the government and local banks into insolvency and precipitating a more general economic and social crisis that profoundly circumscribes the government's ability to raise revenue.

The SDRM, however, offers a mechanism under which such a scenario can potentially be averted. Much like Chapter 11 of US bankruptcy law, under which private firms can file a motion in order to suspend legally payments to all creditors apart from the tax authorities, Krueger's proposal was to allow insolvency-threatened debtor countries to petition the IMF for a halt to debt repayments. Such a mechanism was envisaged to create the financial breathing space that would constrain the herd-like behaviour of creditors and therein avert a financial meltdown.

Under the proposed SDRM-1, the IMF would play a central role by determining which countries would be eligible to participate in the SDRM and by ensuring that member countries adhere to the procedures established in the formal framework. The SDRM-1 described a process in which countries in crisis would call a halt to debt payments as they negotiated with private sector lenders under the jurisdiction of a new international judicial panel. During these negotiations, the IMF would serve to protect the debtor country from litigation.

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The conditions of repayment after a country declared bankruptcy would be negotiated among the creditors by supermajority. Supermajority refers to a situation in which 60-75 per cent of the creditors agree to the terms of restructuring, which would then be binding for the rest of the creditors and, of course, the debtor country. The proposed role of the IMF would be to oversee voting and adjudicate disputes in this process, a role that Anne Krueger suggested would be essential to the success of such a system (Miller, 2002). For the SDRM-1 to be realized, however, the IMF's Articles of Agreement (i.e., its constitution) would have had to be subject to reform. For any such change to occur, the US, which wields veto power in the IMF, has to agree with these changes.

### OPPOSITION TO THE FIRST DRAFT

For markedly different reasons, however, powerful financial interests were fervently opposed to the SDRM-1. Criticism tended to revolve around two main issues. First, there was considerable suspicion about the role to be played by the IMF in the bankruptcy process. On the one hand, private creditors were perturbed at the IMF's informal status as the first creditor to be paid by insolvent governments. Whereas the IMF justifies this prerogative owing to its status as lender of last resort, other creditors do not accept that the IMF should enjoy such a privileged position.

On the other hand, the IMF's role in the SDRM was critiqued in terms of 'moral hazard.' The US Treasury Secretary and international financial interests argued that the IMF proposed role as an arbitrator, and in effect guarantor, of bad loans would make a crisis more likely to occur. The suggestion is that if creditors know that IMF financing helps crisis-prone countries stave off default, the latter are more willing to lend to such countries at lower interest rate spreads than would prevail if the IMF did not exist. The IMF's presence thus weakens pressure on governments to pursue policies – such as sustainable fiscal policies and sound financial supervision and regulation – that could help prevent crises (Lane and Phillips, 2001).

In deepening the moral hazard argument, critics of the SDRM suggested that the mere presence of such a mechanism could similarly distort the market

value of debt instruments, thereby leading to market imperfections and greater potential for crises. The irony is that the SDRM was being presented precisely as an attempt to mitigate widespread market failures as evidenced by repeated financial crises. Moreover, there is little historical evidence to suggest that capital markets operate strictly according to rational principals.

A more trenchant critique offered by institutional investors was that the SDRM could encourage 'strategic defaults', i.e., the suspensions of debt service by countries that actually enjoy the means to repay. However, much like declaring bankruptcy is a last resort in the private sector, owing to the substantial loss of fiscal autonomy and the associated long-term stigma, it is unlikely that sovereign governments would feel this would be anything but an emergency action. Further, the SDRM proposal clearly stated that the case for bankruptcy would have to be well established by the government in question to the IMF before the mechanism would come into effect.

Perhaps more pressing for international financial actors was the worry that creditor rights would be weaker than under the informal and *ad hoc* system that currently prevails. In this vein, one critic from the Brookings Institute, Lex Rieffel, went so far as to suggest that the SDRM was a reincarnation of the International Debt Commission (IDC). In 1979, as a response to growing levels of indebtedness in the South, the United Nations Commission on Trade and Development (UNCTAD) and the G-77 had put forward a proposal for an International Debt Commission (IDC). The IDC was to be a permanent body that would replace both the Paris and London Clubs in dealing with the rescheduling and refinancing of Third World debt. Donors, however, resisted such demands for more elaborate institutionalisation in the fear that the supervision of rescheduling and refinancing might encourage more applications for debt relief, and, more importantly, shift the terms of bargaining in favour of debtor countries (Lipson, 1986). By October 1980, the G-77 had stopped pursuing this project and debt negotiations were to remain informal and exclusionary.

The financial sector's discontent over the SDRM was made apparent through a writing campaign directed to individuals such as the Acting Chairman of the

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*Krueger's proposal...  
was envisaged to  
create the financial  
breathing space that  
would constrain the  
herd-like behaviour  
of creditors and  
therein avert a  
financial meltdown ...*

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IMF's International Monetary and Financial Committee (IMFC), United Kingdom Chancellor Gordon Brown, launched by the directors of the world's most powerful private financial associations, which included the Emerging Markets Traders' Association (EMTA), the Institute for International Finance (IIF), the International Primary Market Association (IPMA), the Bond Market Association, the Securities Industry Association (SIA), the International Securities Market Association (ISMA), and the Emerging Market Creditors Association (EMCA).

The latter, who are almost entirely based in Wall Street with close ties to the US political administration, successfully sought to bring the United States on board in order to defeat the SDRM proposal. In this respect, then Treasury Secretary Paul O'Neill came down firmly against the SDRM, stating that the US executive believed that a market-based approach to strengthening crisis management holds the only promise for success. He suggested, moreover, that the recent debate on the SDRM was counter-productive in that it weakened support for market-driven solutions (Chamberlin, 2003).

**COLLECTION ACTION CLAUSES**

In response to the mounting pressures by the international financial community, US Treasury Undersecretary, John Taylor, put forward an alternative approach, namely: collection action clauses (CACs) in bonds issued by sovereign governments. Essentially, the CAC approach would ensure that creditors remained in control of their loans to debtor nations in times of crisis. The CACs would contain provisions that allow a supermajority of bondholders to approve a process that is believed to make it easier to restructure debt by allowing a majority of creditors to impose a deal. Given the disparate nature of international creditors, which we discussed earlier, a supermajority of creditors is deemed important to overcome the problem of 'collection action,' which occurs when individual creditors consider that their interests are best served by preventing what is termed a 'grab race', i.e., when creditors try to get the best deal possible from the debtor government so as to enforce their claim as quickly as possible. It is believed among the financial community that grab races hinder other creditors and thus may lead them into competition to capture the limited assets

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*... the US executive believed that a market-based approach to strengthening crisis management holds the only promise for success...*

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remaining (Mussa, 2002).

Another advantage of the CACs for the large financial players is that unlike the SDRM, the market-based approach relies on the inclusion of various clauses in individual bond instruments (or bond and loan agreements) and would, as a result, leave jurisdiction to courts in the country/state under whose laws the debt instruments were issued (mostly New York and London). It is also the case that the current outstanding debt of sovereigns would remain untouched until maturing obligations are replaced with new issues containing CACs (Boorman, 2002).

**THE SECOND VERSION OF THE SDRM**

In response to these reactions, Krueger revised her proposal, once again, by devising a more market-based version in line with Taylor's insistence on a decentralized approach that was based on a broader use of CACs (Krueger, 2002). Krueger's modified SDRM-2 effectively reduced the amount of control the IMF had over how the standstill (a temporary suspension of payments) would work, and over how debts would be restructured. A caveat is in order here. Despite the fact that the role of the IMF is downplayed, it should be recalled that the ability of the Fund to provide a 'seal of approval', and thereby signal the creditworthiness of a debtor nation to its international creditors, makes the Fund an integral and coercive feature in not

only the negotiation of debt but also the reproduction of the status of private financial markets. Moreover, embracing the notion that a near-default on sovereign debt may be worked out through legal frameworks and an IMF-centred international agreement, plays an important role in both normalizing and disciplining the power of transnational capital over sovereign states (IMF, 2003). In doing so, the Fund also serves to put forward a particular version of reality that stands in contrast with contesting views, most notably the many voices who have been calling for debt cancellation over the past few decades – organizations such as: Jubilee 2000, South Centre, Debt Relief International, the AFL-CIO (American Federation of Labour-the Congress of Industrial Organizations), and the Mercy Foundation.

A number of important factors concerning the reformulated SDRM should be underlined. First, the SDRM-2 was neither transparent nor inclusive. The

only ostensibly independent forum attached to the SDRM-2 process was the proposed Sovereign Debt Dispute Resolution Forum (SDDRF). According to Krueger, the SDDRF was to be set up as 'a legal body whose functions would be to register claims and resolve disputes [and] would be independent of the Fund and its Executive Board, in parallel with approaches used in other organizations' (IMF, 2003). Nevertheless, it should be noted that the powers of the SDDRF were limited in two ways. First, although the IMF had stated that the SDDRF should be independent of the Fund, it had also highlighted that it would retain a veto over SDDRF decisions.

Second, the SDRM-2 did not include citizen participation in the resolution processes of financial crises. On the one hand, the SDRM-2 preferred a *laissez-faire* approach, allowing market participants more power in the default procedures. This approach was clearly designed to increase the coercive power of transnational capital over debtor countries. Private financial institutions, led by their association, the Institute of International Finance, played a tactical game of supporting collective action clauses in the apparent hope of killing the plan for a judicial mechanism that would in effect reduce their power. On the other hand, as is clear from its response to the Meltzer Commission, the Treasury did not want the IMF to assume a more independent existence, nor does it want to see the creation of a new and truly global financial institution that could oversee such processes, as this could entail the threat of moving toward a truly multilateral as opposed to unilateral form of norm-creating and decision-making processes (*Financial Times*, April 8, 2002; *Economist*, April 6, 2002).

It should also be highlighted that the official debates on the SDRM have excluded developing countries. In fact, up until the Annual Meeting of the IMF and World Bank in early Autumn 2002 (which included the G-7 Finance Ministers), official discussions surrounding sovereign debt default have taken place exclusively between the Fund and the US Treasury. Given the importance of this issue to industrialized countries, and acting under strong pressure from transnational investor groups, the SDRM was not raised for discussion at the UN Financing for

Development Conference at Monterrey, Mexico in March 2002 despite the self-proclaimed inclusionary and democratic nature of the gathering, which involved civil society organizations, the IMF, the World Bank, the World Trade Organization, the G-7 countries and the developing world (Soederberg, 2004). Indeed, an act of exclusion is often necessary to bring together 'like-minded' groups and individuals to the table in order to forge a 'consensus'.

The SDRM would also be reserved for what the IMF deems as 'important' emerging market economies, and thus is not applied across the board to all classes of debtors, such as the Highly Indebted Poor Countries (Greenhill, 2002). More importantly, the debates surrounding the SDRM seem to normalize the notion of sovereign debt default rather than focus attention on the underlying structural problems that threaten to make this socially catastrophic occurrence a potential reality for countries across Latin America (Brazil and Uruguay currently have the most precarious debt scenarios). Indeed, the fact that international policymakers are seriously debating the issue indicates that they recognise the possibility of sovereign default being an unfortunately regular occurrence in the world economy.

#### **SOCIAL RISK AND DEBT RESTRUCTURING**

During the 2003 Annual Meetings of the World Bank and IMF, the International Monetary and Finance Committee (IMFC) officially rejected the SDRM and welcomed the inclusion of CACs. The

IMFC also welcomed the announcement that, by June 2003, those European Union countries issuing bonds under foreign jurisdictions will include CACs. The Mexican government was the first country to include CACs in its sovereign bond issues in 2003. However, by shelving the plans for the SDRM, the IMF effectively gave up on a pre-emptive solution to sovereign insolvency and financial crises. Whereas the SDRM in both its incarnations aimed to prevent the kind of financial meltdowns that have been seen repeatedly over the last decade, the CACs are merely a manner of ensuring a loan creditor cannot hold up debt negotiations following insolvency. CACs therefore formalise the system of debt renegotiation that has operated in an ad hoc manner until the present without introducing any *a priori* mechanisms to

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*the US Treasury did not want the IMF to assume a more independent existence... as this could entail the threat of moving toward a truly multilateral as opposed to unilateral form of norm-creating and decision-making processes...*

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reduce the likelihood of catastrophic crisis, nor recognising the wider array of social interests that are affected by debt restructuring.

Indeed, neither the IMF's SDRM nor the CAC's explicitly recognise the potential conflict between the financial risks of investors and the social risks incurred by the populations of heavily indebted countries. Both the SDRM and CAC solutions to sovereign default offer some positive features – respectively: the formalised pause of debt repayment to avert a meltdown, and stopping individual creditors from halting general negotiations – yet both are silent on the wider social issues. One important factor in this respect is the manner in which, under the current system and within the SDRM and CAC proposals, sovereign governments are treated in the same manner as private corporations in debt negotiations, rather than as political institutions that have duties to perform in order to uphold the human rights of their citizenry.

In contrast, many high-profile NGOs, including Jubilee 2000, have been arguing that there is an urgent need to formalise the restructuring of sovereign debt upon an internationalised version of Chapter 9 of the US legal code. The latter is a specific set of statutes that applies to default of public institutions such as municipalities. Unlike Chapter 11, which applies to corporations, Chapter 9 specifically recognises that when a public governmental institution enters into insolvency, the subsequent debt restructuring must take into account the human and social rights of the population that depends upon this institution for education, health and other forms of welfare provision. In this respect, the Jubilee campaign has demonstrated that Chapter 9 bankruptcy proceedings in the US offer a manner of dealing with public insolvency that is both more humane and democratic.

First and foremost, within Chapter 9, it is stated that a municipality is not expected to stop providing basic social services essential to the health, safety and welfare of its inhabitants in order to pay its creditors. In this respect, the insolvent government should be able to agree a restructuring package that is sustainable not simply according to the criteria of being able to make future repayments, but to be able

to pay back creditors without jeopardising the future needs and capacities of its population. Clearly, such a proposition raises many questions and there is no simple manner of reaching an agreement over the criteria of sustainable debt restructuring of this type. The only way to establish the necessary criteria is through a transparent and democratic negotiating forum that can address the rights and concerns of all affected parties.

In this respect, the Chapter 9 statute also provides the legal basis for a more inclusive forum in which the conditions for debt repayment can be established. Under Chapter 9, taxpayers have the right to be heard in all matters and to object to the confirmation of the plan (Pettifor *et al.*, 2001). In the case of sovereign default, this would explicitly entail an open and transparent forum in which these discussions can occur with the full participation of civil society groups which would have the opportunity to voice their concerns. Building upon this basis, the solution that Jubilee proposes is to retain the principle of sovereign debtor protection that was raised in the IMF's SDRM, yet combine it with a formalised process that would operate through the appointment of an independent panel, created by the Secretary General of the United Nations, to act as an *ad hoc* court of insolvency in conjunction with the IMF. The IMF itself would be unsuitable for this role owing to a severe democratic deficit that permeates its operations and decision-making processes. Specifically, the IMF does not live up to the transparency requirements that it obliges client countries to embrace.

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Given that Chapter 9 is how municipal and other public institution bankruptcy proceedings are handled in the United States, to generalize such an approach at an international level is far from inconceivable. On the contrary, it has the potential to offer a formalised mechanism through which the financial risks incurred by creditors and borrowing governments can be reconciled with the social risks of populations in the developing world (Kunibar, 1990; Pettifor, 2002). Whereas creditors have generally not been disposed to accept an ordered international insolvency process that would operate under a framework of justice, accountable to the people of the debtor nation as well as creditors, the recent Argentinean crisis suggests that such a framework is

imminently necessary. In the words of the classical political economist Adam Smith: 'When it becomes necessary for a state to declare itself bankrupt ... a fair, open and avowed bankruptcy is always the measure which is both least dishonourable to the debtor and least hurtful to the creditor.'

## CONCLUSIONS

This paper has established that there exists an important need to create adequate governance mechanisms that can efficiently mediate the occurrence of sovereign debt default. The unremitting precariousness of the debt question in Latin America and the continued exposure to short-term capital risks raises the spectre of future turbulence and crises in the region. The destructive impacts of the latter forces analysts and policy makers to consider potential governance mechanisms that can mediate not only the financial conflicts raised, but also the social risks inherent to financial crises and debt repayment.

In this respect, the three proposals overviewed within the paper contain important facets of a comprehensive sovereign debt restructuring mechanism. On the one hand, the IMF's initial proposal established the need for debtor countries on the verge of insolvency to be able to call a temporary halt to loan and interest repayments to avoid a fiscal meltdown. On the other, the CAC mechanism indicated the need to avoid individual creditors undermining generalized restructuring negotiations. Notably, however, the governance mechanism proposed by the Jubilee organisation is the only one that attempts to reconcile the social risks of affected populations with the financial risks of investors. It is also the only one that emphasises the importance of a fully transparent process that enshrines the right of civil society to a voice in the process.

To end, however, it is worth questioning the wider political-economic circumstances under which these discussions of sovereign insolvency are taking place. Indeed, the disturbing fact that sovereign debt default is occurring is not viewed critically in the SDRM debates. At base, we must consider the continued failure of neoliberal economic restructuring strategies to lead to strong and sustained economic

growth in Latin America. In the five-year period 2000-2004, per capita economic growth in Latin America will average 0.2% per annum; which follows an unspectacular 1.4% per annum for the decade of the 1990s (Weisbrot and Rosnik, 2003). These failures underscore the pervasive inability of governments to restrain the worrying trend in public and private debt levels. As *The Economist* recently noted, a new regional development model that can overcome the failings of policy trajectory in the last two decades is a pressing concern (*The Economist*, April 24 2003; Green, 2003).

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