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## **Iraq's Debt Relief: Procedure and Potential Implications for International Debt Relief**

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# Iraq's Debt Relief: Procedure and Potential Implications for International Debt Relief

## Summary

Following the ouster of the Saddam Hussein regime in spring 2003, Iraq's external debt was estimated to be \$125 billion. Reducing this debt to a sustainable level has been a priority of the U.S. government. Since 2003, debt relief negotiations have taken place in a variety of fora and led to the cancellation of a significant amount of Iraq's external debt.

Iraq's external debt comprised four components: Paris Club bilateral debt (\$37.15 billion), non-Paris Club bilateral debt (\$67.4 billion), commercial debt (\$20 billion) and multilateral debt (\$0.5 billion). Debt relief negotiations first led to an 80% reduction of the Paris Club debt. The Paris Club agreement also set the terms for non-Paris Club and commercial debt cancellation levels. A provision of the Paris Club agreement is that Iraq cannot accept a debt cancellation agreement with other creditors on less favorable terms than those reached with the Paris Club. Thus, Iraq is expected to receive no more than an 80% cancellation from all of its creditors. Negotiations with non-Paris Club creditors are ongoing, and resolution of the commercial debt is largely complete.

The negotiations and process of providing debt relief to Iraq may shed some light on the approaches bilateral and corporate creditors take toward providing international debt relief to middle-income countries who would not be eligible for the debt relief already provided to the poorest countries. In light of Iraq's experience, three new precedents appear to have taken shape: (1) a willingness by the international community to grant a stay on the enforcement of creditor rights to collect unpaid sovereign debt; (2) an increased flexibility in Paris Club debt relief decisions; and (3) an unwillingness by successor regimes to claim that their debt is odious and repudiate it.

This report will be updated as events warrant.

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# Iraq's Debt Relief: Procedure and Potential Implications for International Debt Relief

Iraq's debt relief is a priority for both the Bush Administration and Congress. Debt relief is important to U.S. interests for several reasons, including releasing funds to help support Iraq's budget, pay for Iraq's security, and reestablish Iraq's financial standing with international creditors and the financial markets.

Iraq's Saddam-era debt is estimated at \$125 billion and has been the focus of numerous negotiations over the past three years among bilateral, multilateral, and commercial creditors. These negotiations led to an 80% reduction of Paris Club and commercial debt. Negotiations with non-Paris Club bilateral creditors are ongoing. The United States forgave its Saddam-era debt, worth \$4.1 billion, in November 2004.

This report proceeds in three parts. The first provides a snapshot of the Iraq debt situation following the ouster of the Saddam regime. The second discusses subsequent debt relief negotiations and their resolution. The third presents three possible implications for future debt relief cases that arise from Iraq's experience. They are: (1) a willingness by the international community to grant a stay on the enforcement of creditor rights, (2) an increased flexibility in Paris Club debt relief decisions, and (3) an unwillingness by successor regimes to claim that their debt is odious and repudiate it.

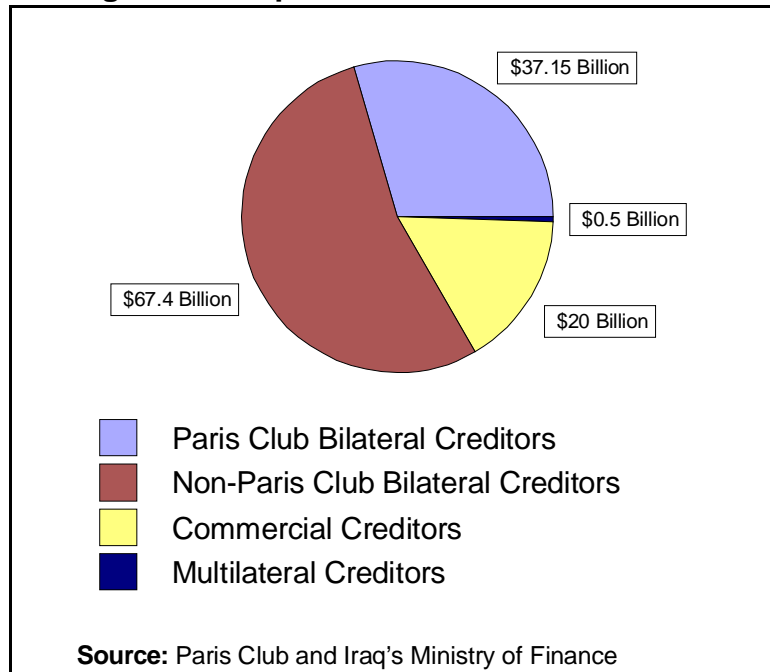
## Iraq's External Debt

The precise dimensions of Iraq's foreign debt obligations are unknown. This is due to disagreements on what Iraq actually owes and how interest on this debt should be calculated (or if it should be counted at all).<sup>1</sup> Iraq's external debt following the end of the Saddam regime was approximately \$125 billion. This debt comprised four components: official Paris Club bilateral creditors (\$37.15 billion), official Non-Paris Club bilateral creditors (\$67.4 billion), commercial creditors (\$20 billion) and multilateral creditors<sup>2</sup> (\$0.5 billion) (**Figure 1**). The first three major components are discussed below.

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<sup>1</sup> Creditor countries use different interest rates and levy different penalties for Iraq's payment arrears. Hence, the debt owed to each creditor can grow at different rates. In addition, Iraq could claim that it should not be expected to pay debt (or interest) accrued after the United Nations Security Council imposed sanctions in 1990 that made it illegal for financial institutions to process Iraq's financial transactions.

<sup>2</sup> Iraq's debts to the World Bank and the IMF were cleared in 2004, largely by contributions from Paris Club donor countries.

**Figure 1. Iraq's Saddam-Era External Debt**

## Paris Club Debt Claims

The Paris Club<sup>3</sup> is the forum where major creditor countries negotiate terms for restructuring or resolving official government-to-government debt. At the time of Iraq's Paris Club debt relief agreement on November 14, 2004, it was determined that Iraq's total external debt to Paris Club countries was \$37.15 billion, including interest.<sup>4</sup> On July 10, 2003, the Paris Club issued a country-by-country breakdown of its member states' claims against Iraq. These figures are reproduced in **Table 1**.

Iraq's debt to the United States consisted of loan guarantees issued between 1983 and 1993 by the U.S. Department of Agriculture for the sale of U.S. agricultural products to Iraq. Iraq defaulted on \$2.19 billion of these guaranteed loans in 1991, just prior to the first Gulf War. The U.S. Department of Agriculture paid off the creditors and assumed the debt. By the end of the Saddam regime, accumulated interest increased Iraq's U.S. debt to approximately \$4.1 billion.

<sup>3</sup> The Paris Club includes the United States and 18 other permanent members: Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Russia, Spain, Sweden, Switzerland, and the United Kingdom. Other creditors are allowed to participate in negotiations on an ad-hoc basis.

<sup>4</sup> Iraq Paris Club Debt Treatment, November 14, 2004. Available at [[http://www.clubdeparis.org/en/countries/countries.php?IDENTIFIANT=397&POSITION=0&PAY\\_ISO\\_ID=IQ&CONTINENT\\_ID=orient\\_afric\\_en&TYPE\\_TRT=&ANNEE=&INDICE\\_DET=](http://www.clubdeparis.org/en/countries/countries.php?IDENTIFIANT=397&POSITION=0&PAY_ISO_ID=IQ&CONTINENT_ID=orient_afric_en&TYPE_TRT=&ANNEE=&INDICE_DET=)].

**Table 1. Total Iraq Paris Club Debt, 2003**  
(in U.S. \$ millions, excluding interest)

Creditor Nation	Debt Owed
Japan	\$4,108.6
Russia	\$3,450.0
France	\$2,993.7
Germany	\$2,303.9
United States	\$2,192.0
Italy	\$1,726.0
United Kingdom	\$930.8
Austria	\$813.1
Canada	\$564.2
Australia	\$499.3
Spain	\$321.2
Brazil	\$192.9
Sweden	\$185.8
Belgium	\$184.5
Finland	\$152.2
Switzerland	\$117.5
Netherlands	\$96.7
South Korea	\$54.7
Denmark	\$30.8
<b>Total</b>	<b>\$20,917.9</b>

**Source:** The Paris Club

## Non-Paris Club Debt Claims

The majority of Iraq's external official debt is owed to non-Paris Club states. The IMF is the only definitive source for non-Paris Club debt and it has not made a country-by-country breakdown of this debt available. In the absence, CRS has reviewed estimates compiled by Jubilee Iraq, an affiliate of the Jubilee organizations which campaign for international debt relief. These estimates are presented in **Table**

2. These are unofficial figures, representing only Jubilee Iraq's compilation of figures reported in the press, think tank reports, or official government remarks.<sup>5</sup>

**Table 2. Non-Paris Club Debt (Various Estimates)**  
(In U.S. \$ million)

Creditor Nation	Debt Owed
Saudi Arabia	\$30,000
Kuwait	\$27,000
China	\$5,800
Qatar	\$4,000
United Arab Emirates	\$3,800
Romania	\$2,500
Serbia	\$2,000
Turkey	\$1,800
Bulgaria	\$1,700
Jordan	\$1,300
Poland	\$564
Czech Republic	\$147
Morocco	\$32
South Africa	\$24
Hungary	\$17
India	\$1

Source: Jubilee Iraq

## Commercial Debt Claims

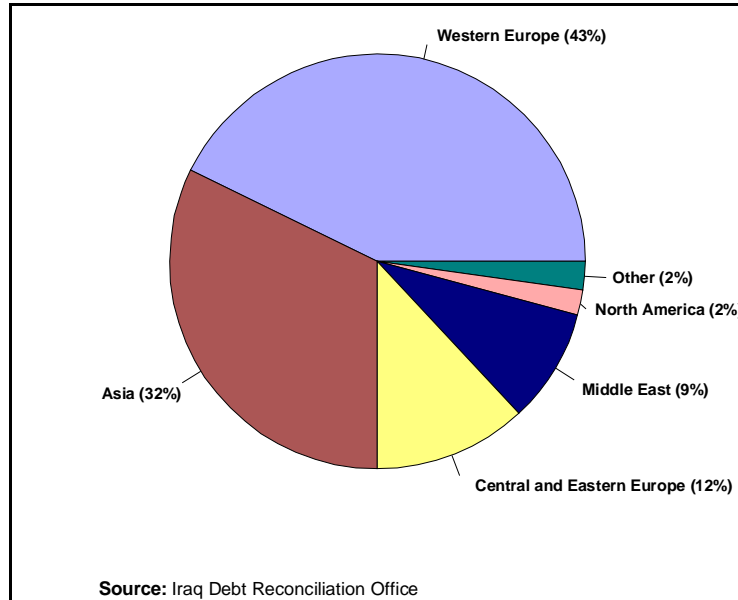
In 2003, Iraq's debt to commercial creditors was estimated to be \$15 billion. In 2005, after further evaluation of claims by Iraq's government, the figure was raised to \$20 billion. Commercial claims are geographically dispersed (**Figure 2**) and most claims are relatively small.<sup>6</sup> Of all the claims received by April 15, 2005 (the date of the most recent public report), 36% of the claims were less than \$1 million and

<sup>5</sup> For the full Jubilee Iraq compilation, see [[http://www.jubileeiraq.org/debt\\_today.htm](http://www.jubileeiraq.org/debt_today.htm)].

<sup>6</sup> Meeting with Iraq's Commercial Claimants, *Iraq Debt Reconciliation Office*, May 4, 2005. [<http://www.eyidro.com>].

37% were between \$1 and \$10 million. U.S. dollar-denominated debt accounted for 72% of all claims, with the remainder the remainder denominated primarily in Japanese Yen (17%) and in Euros (8%).

**Figure 2. Regional Distribution of Iraq's Commercial Claims, 2005**



## The Debt Relief Effort

Following the ouster of Saddam Hussein, the international community began the process of helping Iraq rebuild its economy.<sup>7</sup> An integral component of economic reconstruction following any conflict is resolving old debts and regaining access to the international financial community. Iraq, however, was a unique case. Unlike many of the world's poorest countries, Iraq is considered a middle-income country because of its substantial petroleum reserves. Iraq would likely be able to service its existing debts once its petroleum industry was functioning. Many analysts thus argued that Iraq appeared to be a better candidate for so-called "debt flow" treatment, involving rescheduling its official debts until it had the capacity to repay instead of cancelling them completely as is done for the poorest countries lacking any natural resources that can be used to generate revenue. Others asserted that if Iraq's future oil revenues were used to fund repayment of old debts, not enough would remain to fund its current and future economic needs.

Granting a stay on the enforcement of any debt claims was one of the first major decisions following the end of the Saddam regime. In May 2003, the United Nations lifted sanctions and sheltered Iraq from a potential rush of debt claims. U.N. Security Council Resolution (UNSCR) 1483 prohibits any country from initiating debt claims

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<sup>7</sup> See CRS Report RL31944, *Iraq's Economy: Past, Present, Future*, coordinated by Jonathan Sanford.



against the proceeds of Iraq's petroleum or gas industries until December 31, 2007.<sup>8</sup> Until that time, the United Nations requires any proceeds from these industries be deposited in the Development Fund for Iraq, held by the Central Bank of Iraq. Additionally, UNSCR1483 requires countries to transfer any previously frozen Iraqi assets to the Development Fund for Iraq. Other Iraqi exports and foreign Iraqi assets (besides those covered by diplomatic immunity or frozen) were left vulnerable to attachment because they are not covered by the UNSCR, but their total value appears to be small compared to the country's outstanding debts.

On May 28, 2003, President Bush signed Executive Order (EO) 13303, directing U.S. agencies to implement UNSCR 1483 as it relates to Iraq's debt held by the United States.<sup>9</sup> In contrast to UNSCR 1483, the EO has no sunset date provision. In an additional order (EO 13364), President Bush exceeded the terms of UNSCR 1483 to shield the assets of Iraq's central bank from potential claims.<sup>10</sup>

Discussion of cancelling Iraq's debt began soon after the stay was granted on claims of Iraq's assets. Led by the Bush Administration, a consensus was reached that Iraq would receive debt relief on terms that were unique for its economic resources, but not unprecedented given the political situation. Debt relief has been provided for various countries for political and economic reasons. The United States, for example, has provided bilateral debt relief to Egypt, Pakistan, Jordan, and Poland.

## **Paris Club Debt Relief**

The Paris Club is an informal arrangement among creditor countries to abide by a fixed set of rules and principles for debt relief that have been agreed on by its members. Paris Club members meet periodically to reschedule, and in some cases collectively cancel, the debts owed to them by other countries. The U.S. share of any Paris Club debt relief must be appropriated by Congress.

Since the Paris Club was the most organized of all of Iraq's creditors, and included the major industrialized countries, it was able to start the debt relief negotiations and establish the precedents that other bilateral and commercial creditors would need to follow.

In September 2003, the G7 Finance Ministers called on the Paris Club "to make its best effort to complete the restructuring of Iraq's debt before the end of 2004."<sup>11</sup> President Bush appointed James A. Baker III as his personal envoy on the issue of

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<sup>8</sup> United Nations Security Council Resolution Number 1483, U.N. Doc S/RES/1483, Section 22, May 22, 2003.

<sup>9</sup> The President of the United States, Executive Order 13303 — Protecting the Development Fund for Iraq and Certain Other Property in Which Iraq Has an Interest, 68 F.R. 31931, May 28, 2003.

<sup>10</sup> The President of the United States, Executive Order 13364 — Modifying the Protection Granted to the Development Fund for Iraq and Certain Property in Which Iraq Has an Interest and Protecting the Central Bank of Iraq, 69 F.R. 70177, November 29, 2004.

<sup>11</sup> Statement of G-7 Finance Ministers and Central Bank Governors, September 20, 2003.

Iraq's debt in December 2003. Secretary Baker traveled to Europe, Asia, and the Middle East for discussions with foreign government officials where most countries agreed to provide some debt relief to Iraq.

The Baker appointment, and the ensuing supportive response from other Paris Club countries, showed that the major countries were interested in cancelling Iraq's external debt even though Iraq had the natural resources to eventually service its debts by itself. Since Iraq did not fit neatly into any of the existing Paris Club debt relief terms, the United States and other Paris Club members created a new set of Paris Club rules, the Evian Approach to facilitate Iraq's debt relief.

Prior to the Iraq case, Paris Club debt cancellation (rather than debt rescheduling) was only available for the poorest countries. Paris Club members began offering debt cancellation in addition to debt rescheduling in 1988. At the 1988 Toronto meeting of G7 Finance Ministers, Paris Club members agreed to extend to poor countries up to one-third forgiveness of their bilateral debts.<sup>12</sup> Over the next decade, the Paris Club gradually increased the amount of debt that it would be willing to cancel from 33.33% in 1988 to 90% in 1999.<sup>13</sup> Iraq, however, did not qualify for poor country debt relief due to its substantial petroleum reserves and thus a new framework would be needed to cancel Iraq's debts.

**Evian Approach.** Strong Bush Administration support for Iraq debt relief likely contributed to the Paris Club's reshaping of its approach to debt relief in the runup to the 2003 Evian G8 Summit. The new Evian Approach introduces a new strategy for determining Paris Club debt relief levels that is more flexible and can provide debt cancellation to a greater number of countries than was available under prior Paris Club rules.

Instead of using economic indicators to determine eligibility for debt relief, as had previously been done, all potential debt relief cases are now divided into two groups: the heavily indebted poor countries (HIPC) and non-HIPC countries.<sup>14</sup> HIPC countries will continue to receive assistance under Cologne terms, which sanction up to 90% debt cancellation. All other countries will be assessed on a case-by-case basis.

Under the Evian approach, a country seeking debt relief first undergoes an IMF debt sustainability analysis. This analysis determines whether the country suffers from a liquidity problem, a debt sustainability problem, or both. If the IMF determines that the country suffers from a temporary liquidity problem, its debts are rescheduled until a later date. If the country is also determined to suffer from debt sustainability problems, where it lacks the current resources to meet its debt obligations and the amount of the debt adversely affects its future ability to pay, the

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<sup>12</sup> Many Paris Club policy decisions are decided during periodic finance ministers meetings of the G7 countries.

<sup>13</sup> More information on Paris Club debt treatment options is available at the Paris Club website: [<http://www.clubdeparis.org/>].

<sup>14</sup> CRS Report RL33073, *Debt Relief for Heavily Indebted Poor Countries: Issues for Congress*, by Martin A. Weiss.

country would be eligible for debt cancellation. During the Iraq discussions, Paris Club members determined that Iraq possessed an unsustainable amount of external debt, and began negotiating to cancel Iraq's debts.

**Iraq's Paris Club Agreement.** On November 21, 2004, the United States and other Paris Club members agreed on a debt relief program for Iraq providing a three-phase debt reduction of 80% of Iraq's external debts. Going into the Paris Club meeting to consider Iraq's debt, the United States was reportedly pressing for a 95% reduction of all of Iraq's debt to Paris Club members, while the Europeans, led by France and Russia, wanted only a 50% reduction. According to one press account, Germany agreed to support a compromise figure of an 80% reduction, thus tipping the negotiations toward that agreement.<sup>15</sup> According to the official Paris Club program, the terms of the Iraq deal are:

**First Reduction:** cancels 30% of the debt upon signing the bilateral agreements implementing the Paris Club agreement;

**Second Reduction:** cancels an additional 30% after an IMF program is signed; and

**Third Reduction:** cancels the final 20% of debt on completion of the last IMF Board review of three years of implementation of the IMF program.

When fully implemented, the Paris Club's treatment of Iraq's debt will reduce the total debt owed to Paris Club countries from \$38.9 billion to \$7.8 billion. This remainder (20% of the original total), will be rescheduled over a period of 23 years with an initial six-year grace period of repayments.

**U.S. Debt Relief.** On December 17, 2004, the United States forgave \$4.1 billion (half principal and half interest) — 100% of the debt Iraq owed to the United States. However, since the United States writes off debt in net present value terms, not face value, the amount required was much less than the \$4.1 billion. The fair market value of Iraq's debt was determined to be \$360 million by the U.S. Treasury and was appropriated in a reallocation of financial resources for Iraq approved by Congress on September 29, 2004.

**Other Paris Club Country Debt Relief.** Unlike the United States, most Paris Club members waited until Iraq signed an agreement with the IMF in December 2005 to implement their debt relief. Beginning in December 2005, remaining Paris Club members formally implemented their Paris Club debt relief agreement. This commenced the first two stages of Paris Club debt relief. In accordance with the Paris Club agreement under the new Evian Approach, 30% of bilateral debt would be immediately cancelled following signing the bilateral agreement and 30% would be cancelled following the signing of the IMF Agreement.

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<sup>15</sup> Manmohan Singh and Jochen Andritzky, "How the Iraq Deal Was Done," *Euromoney*, September 2005.

## Non-Paris Club Debt Relief

In some country debt relief negotiations, non-Paris club members participate on an ad-hoc basis. In the Iraq case, however, approximately two-thirds of Iraq's debt is held by non-Paris Club countries. Including these countries in the Paris Club negotiations may have been unfeasible and could have made a resolution much more difficult.

Arab creditor countries were not included in the Paris Club discussions, yet Iraq's Paris Club agreement required Iraq to seek terms that are at least equal to the debt relief negotiated with Paris Club members.<sup>16</sup> It may prove difficult to seek such a high rate of debt cancellation from Iraq's non-Paris Club creditors. Moreover, since Paris Club debt relief came with strings attached in the form of IMF conditionality, it may be likely that non-Paris Club members will seek to attach conditions to any debt relief themselves, possibly in the form of preferential access to Iraqi oil, or other business and investment opportunities in Iraq.

During January 2004 meetings with representatives from Saudi Arabia, Kuwait, the United Arab Emirates (UAE), and Qatar — four Persian Gulf countries that, combined, hold approximately \$65 billion of Iraq's debt — Secretary Baker received assurances that the Persian Gulf countries would significantly reduce their Iraq debt holdings once a sovereign government is established.<sup>17</sup> Reportedly, several Middle Eastern countries will start talks with Iraq regarding settlement during the first half of 2006.<sup>18</sup> Many observers suggest that Iraq's neighbors may want to wait on any final debt reduction until they see whether the future government in Iraq will be friendly to them. Arab creditors might also want more formal political arrangements to resolve Sunni-Shiite disputes in Iraq on terms Iraq's Arab neighbors (all Sunni countries) would find more equitable.<sup>19</sup>

Iraq has resolved some of its smaller debts to non-Arab, non-Paris Club creditors. According to the IMF, Iraq's authorities have signed agreements with Malta and Romania. Discussions with Brazil, Bulgaria, Czech Republic, Cyprus, Greece, Hungary, Indonesia, Pakistan, Poland, and Slovakia are well advanced.<sup>20</sup>

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<sup>16</sup> *Iraq Paris Club Comparability of Treatment Provision*, November 21, 2004. [[http://www.clubdeparis.org/en/countries/countries.php?CONTINENT\\_ID=orient\\_afric\\_en&DETAIL\\_DETTE\\_PAGE=4&IDENTIFIANT=397&PAY\\_ISO\\_ID=IQ](http://www.clubdeparis.org/en/countries/countries.php?CONTINENT_ID=orient_afric_en&DETAIL_DETTE_PAGE=4&IDENTIFIANT=397&PAY_ISO_ID=IQ)]

<sup>17</sup> "Baker Secures Promises of Iraq Debt Relief from Gulf Oil States," *Agence France Presse*, January 21, 2004.

<sup>18</sup> "Iraq Optimistic on Gulf Arab Debt," *Reuters*, January 23, 2006.

<sup>19</sup> See CRS Report RL31339, *Iraq: U.S. Regime Change Efforts and Post-Saddam Governance*, by Kenneth Katzman.

<sup>20</sup> *Iraq: Request for Stand-By Arrangement - Staff Report, Staff Supplement*, The International Monetary Fund, January 13, 2006. [<http://www.imf.org/external/pubs/ft/scr/2006/cr0615.pdf>].

## Commercial Debt Relief

The final portion of Iraq's debt are commercial claims estimated at around \$20 billion. These are outstanding commercial claims against various Iraqi guarantors that arose prior to the August 6, 1990 U.N. sanctions imposed when Iraq invaded Kuwait. The Iraqi government retained two U.S. companies, Ernst and Young and Citigroup, to adjudicate these debt claims and to help negotiate various settlements with small and large Iraqi creditors. The Iraq Debt Reconciliation Office was established in Amman, Jordan in May 2004.<sup>21</sup> On December 9, 2004, Iraq's Ministry of Finance posted an official query seeking information about commercial claims, including claims held by financial institutions, outstanding against the Iraqi government.

On July 26, 2005, Iraq announced the terms for its commercial debt renegotiation. For small creditors (less than \$35 million), Iraq would settle claims through a cash buyback and cancellation. For larger claims, Iraq would seek a debt-for-debt swap. For small creditors, the cash purchase price would equal 10.25% of the outstanding claim up to a maximum of \$4.3 million. Larger creditors would receive, in line with the 80% debt cancellation requirement established by the November 2004 Paris Club agreement, new bonds carrying a face value of \$200 for every \$1,000 of their old debt. The new bonds are so-called "Eurobonds," arranged in London and trading in U.S. dollars. The bonds are guaranteed by the Iraqi government, will pay an annual coupon of 5.8%, are due to mature in 2028, and are guaranteed by the Iraqi government.

The new Eurobonds have been welcomed by investors and the exchange appears to have been successful. The bonds, which traded in the grey market prior to issuance at around 11% yield. This is also an optimistic sign for the Iraqi economy. Several developing countries, such as Argentina and Brazil were forced to pay much higher yields when they re-entered the bond market following their own recent economic crises. Prices of the bonds have continued to rise and were trading at around 9.25% yield following their launch on January 23, 2006.

As of April 3, 2006, the Iraq government has settled \$18.4 billion of its commercial claims.<sup>22</sup> According to Iraq's Ministry of Finance, they have concluded three installments of the cash buyback offer for small debt holders, and one debt-for-debt exchange for large debt holders. Some remaining claims are in arbitration process, and Iraq's Ministry of Finance intends to an additional installment of the cash buyback offer by July 2006 to resolve these claims.

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<sup>21</sup> The Iraq Debt Reconciliation Office. [<http://www.eyidro.com/>].

<sup>22</sup> "Iraq Announces Results of Commercial Debt Settlement," Republic of Iraq Ministry of Finance Press Release, April 3, 2006.

## Potential Policy Precedents for International Debt Relief

The negotiations and process of providing debt relief to Iraq may shed some light on the approaches bilateral and corporate creditors take towards providing debt relief to middle-income countries who are not eligible for the debt relief already provided to the poorest countries. In light of Iraq's experience, three new precedents appear to have taken shape: (1) a willingness by the international community to grant a stay on the enforcement of creditor rights to collect unpaid sovereign debt; (2) an increased flexibility in Paris Club debt relief decisions; and (3) an unwillingness by successor regimes to claim that their debt is odious and repudiate it.

### Granting a Stay on the Enforcement of Creditor Rights

In the Iraq case, implementing a stay on the enforcement of creditor rights to use litigation to collect unpaid sovereign debt was a major priority and was implemented by UNSCR 1483 shortly after the collapse of the Saddam regime. Implementation of this stay occurred with very little debate over whether such a comprehensive debt shield should be used.

In fact, such a debate did occur between 2001 and 2003, over the introduction of a debt shield mechanism at the IMF for countries facing economic crisis. At the time, there was concern that several South American countries, including Argentina and Brazil, may default on their international debts. During this debate, the U.S. Administration led the opposition to a comprehensive debt shield mechanism and the proposal was eventually withdrawn. It appears that after Iraq, however, such a mechanism is feasible if it is introduced in a political context such as the United Nations rather than economic/financial one like the IMF, and that it is an ad-hoc process, not attached to any formal mechanism for debt resolution.<sup>23</sup>

Sovereign bonds (government issued debt) are the primary form of developing country debt. These bonds are held by many types of investors, both large and small, and represent a major shift in the types of country debt. When countries ran into economic difficulties during the economic crises of the 1980s, their debt consisted primarily of bank loans, issued by a small number of commercial banks. It was relatively easy for the banks to work together with delinquent countries and arrange terms to restructure the debt. There is now a much wider spectrum of investors in sovereign bonds, creating much costlier and more difficult resolutions. However, outside of the Paris Club, there is no formal mechanism to coordinate debt restructuring negotiations between creditors and the debtor government.

To address these concerns, in 2001, the IMF proposed creating the Sovereign Debt Restructuring Mechanism (SDRM) to help negotiate debt restructurings in general. Among other things, the IMF's proposal would afford rights to defaulting countries similar to those afforded bankrupt companies in the United States under

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<sup>23</sup> Anna Gelpern, "What Iraq and Argentina Might Learn from Each Other," *Chicago Journal of International Law*, Summer 2005.

Chapter 11 of U.S. bankruptcy codes. A stand-still on debt payments would go in effect, while countries renegotiated their debt contracts with their creditors through a dispute resolution mechanism administered by the IMF. The debt stand-still was considered one of the most important components of the proposed SDRM.<sup>24</sup> It also proved to be the one of the most highly contested issues concerning the SDRM proposal.<sup>25</sup>

The SDRM proposal was rejected by the Bush Administration, the private sector, and many Members of Congress. The Bush Administration advocated a more decentralized, market-oriented approach that would include clauses in sovereign bond contracts, known as Collective Action Clauses (CACs) that would stipulate how the financial contracts would be resolved pending a financial crisis or default.

A majority of commercial creditors also discouraged the establishment of the SDRM. For example, the Institute for International Finance (IIF), a global association of financial institutions, was concerned that an international bankruptcy court could inhibit investor confidence, delay renewed access of debtor countries to capital markets that use the SDRM, and possibly lead to contagion of other emerging markets.<sup>26</sup> According to the IIF, the SDRM also might encourage moral hazard by encouraging other sovereign borrowers not to pay debts in order to receive standstill protection.

The essential concern with the SDRM was whether the United States and the international community should condone an official stay on creditor rights through a litigation shield such as the SDRM. After two years of debate, the proposal was eventually bypassed at the spring 2003 IMF meetings, when the United States government threw its support behind including CACs in new bond contracts instead of creating a new IMF function.

However, only a few months after these meetings, the United Nations Security Council Iraq resolutions were passed, providing essentially the exact protections to Iraq that were rejected at the IMF. Financial analysts note that immunizing Iraq's debts from foreign claims through a U.N. Security Council Resolution is a radical move in the history of sovereign debt negotiations. In the past, the U.S. government has taken a rather hands-off stance that let the financial markets resolve debt disputes. This approach, known as the "restrictive approach to state immunity," and codified through the Foreign Sovereign Immunities Act of 1976 (P.L. 94-583), established that foreign states are not immune from jurisdiction regarding, among

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<sup>24</sup> "A New Approach to Sovereign Debt Restructuring: Preliminary Considerations, International Monetary Fund," Nov. 30, 2001, available online at [<http://www.imf.org/external/NP/pdr/sdrm/2001/113001.pdf>].

<sup>25</sup> Blustein, Paul, "IMF Cuts Disputed Clause from Debt Plan," *Washington Post*, January 8, 2003.

<sup>26</sup> Action Plan of the Institute for International Finance, Special Committee on Crisis Prevention and Resolution in Emerging Markets, April 2002.

other things, commercial activity including foreign debt.<sup>27</sup> Thus, the U.S. government typically allowed creditors to sue foreign governments regarding debt claims, but have not intervened on behalf of U.S. creditors or the foreign government.<sup>28</sup>

The Iraq case thus illustrates that the United States and the international community are willing to shield a debtor from its creditors on an ad-hoc basis, without a formal international bankruptcy regime. This can be accomplished multilaterally through U.N. Security Council Resolutions or bilaterally, on a case-by-case basis, through executive orders. Since these measures were not taken in other recent financial crisis-afflicted countries, such as Argentina or Brazil, it appears that policymakers are only willing to use such measures selectively, and for countries that exhibit a perceived threat to U.S. and international security. This understanding is made more explicit by implementing the stay through the United Nations, a political institution seen principally as focused on international security, rather than the International Monetary Fund, which is primarily a financial institution.

## Flexibility of Paris Club Agreements

In addition to providing a precedent for a comprehensive debt shield, the Iraq case helped institutionalize increasing flexibility in Paris Club debt restructuring treatments. Prior to Iraq, Paris Club members adhered to a relatively strict set of rules to determine which countries would be eligible for debt relief and for how much debt relief, based on their economic situation. However, whenever a new situation arose where Paris Club members wanted to provide debt relief, but existing rules would not support it, new rules were created offering deeper and deeper debt reduction. Thus the Toronto terms, introduced in 1988 begat Houston Terms in 1990, London Terms in 1991, Naples Terms in 1994, Lyon Terms in 1996, and finally Cologne Terms in 1999, each offering increased and greater debt relief.

Cologne terms, part of the Heavily Indebted Poor Country Program, allow for up to 100% debt cancellation for a select group of countries that the IMF and World Bank deem to be the most heavily indebted. The prevalence of debt reduction in Paris Club operations has led to what some have called the “slippery slope towards HIPCization,” as increasing amounts of debt cancellation have been requested for countries on geo-political rather than economic grounds.<sup>29</sup> Pakistan, for example, is not a HIPC country, yet it is considered to be an integral partner in U.S. anti-terror efforts. When debt relief was sought for Pakistan in 2001, the Paris Club negotiated a special ad-hoc arrangement on-near Cologne terms even though Pakistan did not economically qualify to receive such treatment.

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<sup>27</sup> For more information on state immunity, see CRS Report RL31258, *Suits Against Terrorist States By Victims of Terrorism*, by Jennifer K. Elsea; and Tom McNamara, *A Primer on Foreign Sovereign Immunity*, Davis Graham & Stubbs LLP, available at [<http://www.worldservicesgroup.com/publications.asp?action=article&artid=1223>].

<sup>28</sup> Gelpern, p. 396.

<sup>29</sup> Callaghy, Thomas M. “The Paris Club and International Economic Governance: Double Crisis and Debt,” in Brigitte Granville and Vinod Aggarwal ed., *Sovereign Debt: Origins, Management and Restructuring*, Royal Institute for International Affairs, 2003, p. 165.



Instead of continuing to treat special cases, like Pakistan, under ad-hoc terms, the Paris Club formalized a new system of more flexible debt relief arrangements with Iraq and the new Evian Approach. As discussed earlier in the report, following Evian, potential debt-relief cases are divided into two groups, HIPC and non-HIPC. The 38 poor and indebted countries that are part of the HIPC program will continue to receive debt relief under the terms agreed to at Cologne. All other countries will be treated on a case-by-case basis with any debt relief determined by IMF debt sustainability analysis, with the option for three-part phased debt relief such as Iraq is receiving.

The introduction of Evian terms was crucial for Iraq's debt relief plan. "Without Evian in place," commented *Euromoney*, "it's hard to imagine the Paris Club members would have signed off on a deal as nakedly political as Iraq's."<sup>30</sup> Some argue that the Evian Agreement is unfair, and opens the door even wider to political debt relief, using resources that could potentially go to increased debt relief or foreign assistance to poor and developing countries. For example, Indonesia, Kenya, and Georgia recently emerged from decades of authoritarian and autocratic rule, and are saddled with extensive government debt, yet they received nowhere near the level of international exposure that has been given to the Iraqi situation.<sup>31</sup> "It's an outrageous double standard," according to Salih Booker, the head of Africa Action, a Washington-based lobbying group.<sup>32</sup>

It appears that the new flexibility evidenced by the introduction of the Evian approach is continuing. Following Evian, Paris Club members introduced an even greater flexibility in 2005 by allowing countries to buy back their debt, a policy that had previously not been allowed. In 2004, Russia, using proceeds generated by record high petroleum prices, approached the Paris Club and requested to buyback some of its debt. Germany refused to participate, scuttling a Paris Club deal. A deal was eventually agreed on in May 2005 that allowed Russia to repay \$15 billion in debts at par.<sup>33</sup> According to this agreement, Russia debts were paid ahead of schedule without requiring a pre-payment penalty.

Following the Russia agreement, additional buyback deals were reached with Nigeria and Peru. In October 2005, a deal was reached where Nigeria was allowed to buy back some of its debt at a discount, leading to debt relief worth \$18 billion and a total reduction of Nigeria's Paris Club debt from \$36 billion to \$6 billion. The Peru buyback, like Russia, was at par, and will lead to Peru pre-paying \$17 billion of its Paris Club debt.

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<sup>30</sup> Manmohan Singh and Jochen Andritzky, "Paris Club Members Adopt to New Rules," *Euromoney*, September, 2005.

<sup>31</sup> Joseph Siegle, "After Iraq, let's forgive some other debts," *International Herald Tribune*, February 19, 2004.

<sup>32</sup> Quoted in Sudarson Raghavan, "African Advocates to U.S.: Reduce Our Debt Like Iraq's," *The Miami Herald*, February 20, 2004.

<sup>33</sup> "Paris Club Reaches \$15B In Debt Repayment Deal With Russia," *MosNews*, May 13, 2005, available at [<http://www.mosnews.com/money/2005/05/13/parisclubfinal.shtml>].

As some analysts have illustrated, introducing flexibility into Paris Club arrangements was well underway prior its handling of the Iraq case.<sup>34</sup> However, it appears that the precedent set by Iraq may open the door to increased debt relief for middle-income countries. Combined with the new willingness to engage in debt-buybacks, resolving international debt may be easier in the coming years.

## Implementing an Odious Debt Strategy

Some analysts have argued that Iraq's debt is odious, and therefore may be repudiated under international law. There are three generally agreed upon components of the legal principle of odious debt: (1) the general population does not consent to the borrowing; (2) the proceeds do not benefit the general population or the state; (3) and the creditor knows both of these facts at the time of lending.<sup>35</sup> However, the concept of odious debt does not appear to be well established in international law and has never been cited by either a national or international tribunal as reason to repudiate a debt claim.<sup>36</sup>

Repudiating Iraq's debts under the concept of odious debts was raised by some Members of Congress in 2003 in H.R. 2482, *The Iraq Freedom From Debt Act*, introduced by Representative Carolyn Maloney. The bill, which was not enacted, called on the IMF and the World Bank to cancel Iraq's odious debt and called on Congress and the President to urge fellow Iraqi creditors to cancel their owed debt as well.

Iraqi officials have steadfastly claimed that they would not seek repudiation under the odious debt concept. In an interview with *Euromoney* in September 2004, Iraq's Minister of Finance, Adil Abdul Mahdi said:

Iraq's need for very substantial debt relief derives from the economic realities facing a post-conflict country that has endured decades of financial corruption and mismanagement under the Saddam regime. Principles of public international law such as the odious debt doctrine, whatever their legal vitality, are not the reason why Iraq is seeking this relief.<sup>37</sup>

Iraq preferred to seek a reduction of its debts through normal and official channels. The Paris Club's Iraq agreement, reached three months after the Minister's *Euromoney* interview, provided an 80% total reduction and set the parameters for the ongoing debt reduction efforts with non-Paris Club and commercial creditors. This allowed Iraq to receive its debt relief without the potential destruction of creditor relationships than can come about with a debt default.

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<sup>34</sup> See Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery*, Brookings Institution Press, 2003.

<sup>35</sup> Todd Moss, Scott Standley, and Nancy Birdsall, "Double Standards, Debt Treatment, and World Bank Country Classification: The Case of Nigeria," *Center for Global Development*, November 2004, p. 33, and Gelpern, p. 403.

<sup>36</sup> Gelpern, pg. 406. See also the discussion in CRS Report RL31944, *Iraq's Economy: Past, Present, Future*.

<sup>37</sup> Cited in Gelpern, p. 406.

In retrospect, it appears that an odious debt approach may have been difficult for Iraq since many of Iraq's debts were taken for economic development or commercial purposes and appear legitimate.<sup>38</sup> None of the debt in question was borrowed during the period when Iraq was under U.N. sanctions, when large amounts of Iraq's oil revenue were diverted for the construction of Saddam Hussein's palaces and other indulgences. It is also not evident that, at least to a degree greater than in other countries, the proceeds of the development loans were diverted to personal use or to fund oppression within Iraq.

Iraq's refusal to use an odious debt approach begs the question: under what circumstances could the odious debt principle be applied? In its current form, the odious debt doctrine, according to one analyst, "offers no meaningful guidance to shape decisions on lending to emerging markets."<sup>39</sup> One proposal is for the IMF or some other international body to assess a regime's legitimacy and make an odiousness determination, thus allowing any future government to declare any sovereign debt incurred by the previous "illegitimate" regime odious and repudiate it.<sup>40</sup> Such a sanctions regime may act as an incentive to creditors, both private and public, to not loan to problem regimes knowing that a successor government can legitimately repudiate the former regime's debts. U.S. foreign assistance to the new regime could also be made contingent on repudiation of odious debts.

On the other hand, the United States, or other nations, may not necessarily agree with the odiousness determination for various political reasons. It also may be difficult to make such a determination while a problem regime is in place, especially if other forms of political and economic statecraft are being employed.

However, given that odious debt concept appears unusable in its current format, refashioning the odious debt concept as a sanctions regime represents one innovative way to reduce the flow of financial resources to undesirable governments. Such a system would create additional incentives for creditor governments and the commercial sector to avoid lending to these regimes by creating the legal precedents necessary for a successor regime to repudiate the debt.

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<sup>38</sup> CRS Report RL31944, *Iraq's Economy: Past, Present, Future*, coordinated by Jonathan Sanford.

<sup>39</sup> Gelpert, 412.

<sup>40</sup> Michael Kremer and Seema Jayachandran, "Odious Debt: When Dictators Borrow, Who Repays the Loan?" *The Brookings Review*, Spring 2003.