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## DEVELOPING COUNTRIES DEBT CRISES, INTERNATIONAL FINANCIAL INSTITUTIONS AND INTERNATIONAL LAW: SOME PRELIMINARY THOUGHTS

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# Developing Countries Debt Crises, International Financial Institutions, and International Law: Some Preliminary Thoughts

By Daniel Bradlow\*

## A. Introduction

Debt crises in developing countries, although not unprecedented, first became significant international financial threats when Mexico announced in August 1982 that it could no longer service its external debts. Since then, the International Financial Institutions (IFIs), particularly the World Bank Group and the International Monetary Fund, have played key roles in helping successive waves of their member countries deal with debt crises. While the details of their role in each of these waves have differed, they have always offered these member countries both financial services and technical advice on how to negotiate and manage their way out of their debt troubles.

While the question of how effectively the IFIs have performed their international economic, financial, social, environmental and developmental responsibilities in their work with these debtor countries has been extensively analyzed and debated, their compliance with their applicable international legal obligations has been less rigorously examined. The IFIs' responsibility in this regard, is based on their mandates, as defined in their Articles of Agreements,<sup>1</sup> and gen-

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<sup>1</sup> International Bank of Reconstruction and Development Articles of Agreement, 27 December 1945, UNTS 2, 13, Art. 1 (IBRD Articles of Agreement); International Development Association Articles of Agreement, 24 January 1960, UNTS 439, 249, Art. 1 (IDA Articles of Agreement); Agreement Establishing the Inter-American Development Bank, 30 December 1959, UNTS 389, 69, Art. 1 (Agreement Establishing the IADB); Agreement Establishing the African Development Bank, 4 August 1963, UNTS 510, 3,

eral principles of customary international law.<sup>2</sup> Based on the former, the IFIs, as a group, are expected to contribute to the long term growth and development of their Member States in ways that are consistent with the overall growth of international trade and that are consistent with, and do not undermine the, international monetary and financial system.<sup>3</sup> Their customary international legal obligations include upholding such principles as *pacta sunt servanda* and *rebus sic stantibus* and respecting the sovereignty of their Member States.<sup>4</sup>

When measured against these legal standards, the IFIs have had a mixed record in meeting their international legal obligations towards their member countries. Until the advent of the current financial crisis, it was clear that the IFIs have effectively helped the totality of their membership avoid the worst case scenario of a breakdown in the international financial system, in general, and in financial flows to developing countries, in particular. However, as is well known, there is an on-going debate about how well they have met their responsibility to promote sustainable development and poverty alleviation in all their member countries – given, for example, the increase over this period in inequality within and between countries.<sup>5</sup> In addition, the way in which the IFIs have implemented their mandates to achieve these objectives has resulted in significant expansion in the scope of their missions, which has led many to raise concerns about their

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Art. 1 and 2 (Agreement Establishing the AFDB); Agreement Establishing the Asian Development Bank, 22 August 1966, UNTS 571, 123, Art. 1 and 2 (Agreement Establishing the ADB); Agreement Establishing the European Bank for Reconstruction and Development, 28 March 1991, ILM 29 (1990), 1083, Art. 1 and 2 (Agreement Establishing the EBRD) and Articles of Agreement of the International Monetary Fund, 27 December 1945, UNTS 2, 39, Art. 1 (IMF Articles of Agreement).

<sup>2</sup> See *Interpretation of the Agreement of 25 March 1951 between the WHO and Egypt*, ICJ Reports 1980, 73, para. 37; the International Law Commission's First Report on Responsibility of International Organizations, UN Doc. A/CN.4/532 of 26 March 2003, Art. 3, and the International Law Commission's Third Report on Responsibility of International Organizations, UN Doc. A/CN.4/553 of 13 May 2005, Art. 8.

<sup>3</sup> IBRD Articles of Agreement (note 1), Art. 1; IDA Articles of Agreement (note 1), Art. 1; Agreement Establishing the IADB (note 1), Art. 1; Agreement Establishing the AFDB (note 1), Art. 2; Agreement Establishing the ADB (note 1), Art. 2; Agreement Establishing the EBRD (note 1), Art. 1 and 2.

<sup>4</sup> It should be noted that over time and through the codification efforts of entities like the International Law Commission and the International Law Association the customary international legal obligations of international organization are likely to evolve.

<sup>5</sup> See, for example, the United Nations Development Programme's Human Development Report, Globalization with a Human Face, available at: <http://hdr.undp.org/en/reports/global/hdr1999/>.

encroachment into the areas of responsibility of other international organizations and the efficacy and the legitimacy of their roles in the international financial order.

In order to establish this thesis, the next section of this paper will briefly describe the key IFIs, namely the World Bank Group (WBG or WB) and the International Monetary Fund (IMF), and the international legal obligations that arise from their Articles of Agreements. The third section will provide a brief overview of the IFIs' role in the debt crises of their Member States over the 25 year period starting with the onset of the Mexican debt crisis in August 1982 and of their implementation of the applicable international law principles. The fourth chapter will evaluate their compliance with their international legal obligations.

## **B. The IFIs and their International Legal Obligations**

The most prominent IFIs involved in the management of developing country debt are the World Bank Group and the IMF. In legal and governance terms, they remain the prototypes for all other IFIs. Consequently, they will be the focus of this chapter.

### **I. The World Bank Group**

The World Bank Group consists of five separate legal entities: the International Bank for Reconstruction and Development (IBRD); the International Development Association (IDA); the International Finance Corporation; the Multilateral Investment Guarantee Agency; and the International Centre for Settlement of Investment Disputes. For current purposes, the two most relevant members of this group are the IBRD and the IDA (collectively "the World Bank").<sup>6</sup>

Pursuant to its Articles of Agreement,<sup>7</sup> the objectives of the IBRD are (i) assisting in the reconstruction and development of the territories of Members States by facilitating the investment of capital for productive purposes; (ii)

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<sup>6</sup> For more information on the World Bank Group, see: <http://go.worldbank.org/3QT2P1GNH0>.

<sup>7</sup> IBRD Articles of Agreement (note 1), Art. 1.

promoting private foreign investment by means of guarantees or participations in loans and other investments made by private investors; (iii) promoting the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment (iv) arranging loans made or guaranteed by it so that the more useful and urgent projects are dealt with first; and (v) and conducting its operations with due regard to the effect of international investment on business conditions in the territories of Member States. Thus, the IBRD was intended primarily to be a funder of development “projects.”<sup>8</sup> Only in “special circumstance”<sup>9</sup> was it supposed to provide funding for non-project, policy-based purposes.

The purposes of IDA compliment those of the IBRD.<sup>10</sup> They are to promote economic development, increase productivity and thus raise standards of living in the poorest member countries by providing financing to meet their developmental requirements on terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans.

The IBRD raises its funds based on the capital provided by its Member States. At the time of accepting membership, each Member State is allocated a share of the Bank’s capital, based on a formula that depends on such factors as its size and importance in the global economy. The Member State pays a portion of the price in cash and the balance in promissory notes. The IBRD relies on these pledges to raise funding in international financial markets.

The IBRD carries out its purposes principally through loan operations,<sup>11</sup> made either to a member of the Bank or to a public or private entity or enterprises within the territory of a member. When the borrower is not a member government, the loan must be fully guaranteed by the member government in whose territory the project to be financed is located. Consequently, every lending operation of the Bank leads to a loan or guarantee agreement with a Member State.

IDA, because it provides funding on such generous terms, is not self-sustaining. Consequently, its capital is regularly replenished by its Member States. IDA is

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<sup>8</sup> IBRD Articles of Agreement (note 1), Art. 3 Sect. 4(vii).

<sup>9</sup> *Ibid.*

<sup>10</sup> IDA Articles of Agreement (note 1), Art. 1.

<sup>11</sup> The Bank also renders important non-financial services to its members. See the World Bank website, available at: <http://go.worldbank.org/1YXPMBNDO0> and <http://go.worldbank.org/DM4A38OWJ0>.

expected to use these replenishments to extend development credits to Member States with per capita incomes below about 1,506 US Dollar per annum.<sup>12</sup> It provides these Member States with development credits for similar purposes and in similar form to IBRD financing but on significantly more attractive terms (zero-interest loans over 30 years with ten years grace period).

Interestingly, both the IBRD and IDA credit agreements with their Member States appear to be governed by international law.<sup>13</sup> Specifically, their agreements provide that the rights and obligations of the Bank under such agreements shall be valid and enforceable in accordance with their terms notwithstanding the law of any State or political subdivision thereof to the contrary.<sup>14</sup> The agreements also provide for arbitration in event of a dispute.<sup>15</sup>

## II. IMF

According to Article 1 of its Articles of Agreement, the purpose of the IMF is to promote international monetary cooperation through consultation and collaboration; to promote orderly and stable exchange arrangements among members; to assist in the establishment of a multilateral system of payments for international trade; and to make the resources of the IMF “temporarily available” to members “under adequate safeguards” for the purpose of correcting their balance of payments problems “without resorting to measures destructive

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<sup>12</sup> In principle, States are eligible to borrow from IDA provided that their per capita income is below 1,506 US Dollar p.a.; in practice, however, IDA lends to States with a per capita income p.a. of around 925 US Dollar (figures are in 2008 US Dollars).

<sup>13</sup> *Aron Broches*, *International Legal Aspects of the Operations of the World Bank*, *Recueil des Cours* 98 (1959), 297; *John W. Head*, *Evolution of the Governing Law for Loan Agreements of the World Bank and other Multilateral Development Banks*, *American Journal of International Law* 90 (1996), 214. It should be noted that loan agreements with non-sovereign borrowers are always accompanied by guarantee agreements with the borrower’s sovereign that are governed by international law. The loan agreements with state-owned entities are not governed by international law but nonetheless “exclude” the operation of municipal law.

<sup>14</sup> General Conditions for Loans, International Bank for Reconstruction and Development, 1 July 2005, Art. VIII, Sect. 8.01 (as amended through 12 February 2008); General Conditions for Credits and Grants, International Development Association, 1 July 2005, Art. VII, Sect. 7.01 (as amended through 15 October 2006).

<sup>15</sup> General Conditions for Loans, International Bank for Reconstruction and Development (note 14), Art. VIII, Sect. 8.04; General Conditions for Credits and Grants, International Development Association (note 14), Art. VII, Sect. 7.03.

of national or international prosperity” and to shorten the duration and lessen the severity of the disequilibria in the balance of payments of members.<sup>16</sup>

Upon joining the IMF, each Member State is assigned a quota which, like the IBRD share allocations, depends on its size and contribution to the global economy. This quota determines the size of its subscription, which is the amount of funds<sup>17</sup> it is required to place on deposit with the institution, its vote in the IMF, and its access to IMF financing.<sup>18</sup> The amount of financing that the IMF will offer a Member State is a percentage – normally up to 300 % – of its quota. Except for the reserve tranche all IMF financing is subject to the IMF’s policy of conditionality, which refers to the policy and other adjustment measures that the IMF expects the Member State to undertake in return for the IMF financing. The IMF’s financing facilities that involve conditionality include the Stand-By Arrangement, the Extended Fund Facility and the Poverty Reduction and Growth Facility.<sup>19</sup> Apart from these arrangements, the IMF introduced the Supplemental Reserve Facility in 1997<sup>20</sup> and the Contingent Credit Line facility in 1999.<sup>21</sup> The purpose of the conditionality<sup>22</sup> is to ensure that IMF resources are

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<sup>16</sup> See IMF Articles of Agreement (note 1), Art. 1 and The IMF at a Glance, available at: <http://www.imf.org/external/np/exr/facts/glance.htm>.

<sup>17</sup> 25 % of the subscription is provided in SDRs or convertible currency and 75 % in local currency. The first 25 %, is known as the “reserve tranche” and is relatively freely available to Member States and is treated as part of their reserves. See International Monetary Fund, IMF Quotas, available at: <http://www.imf.org/external/np/exr/facts/quotas.htm>.

<sup>18</sup> IMF Articles of Agreement (note 1), Art. 3 Sect. 1.

<sup>19</sup> The Stand-By Arrangement was the first IMF Facility and is the basic means through which it provides financing to its Member States. See *Joseph Gold, The Stand-By Arrangements of the International Monetary Fund: A Commentary on Their Formal, Legal and Financial Aspects* (1970). The Extended Fund Facility (dating from 1974) allows a member country to draw up to a specified amount over a longer term, usually three or four years. The Poverty Reduction and Growth Facility was introduced in 1999. It replaced the Enhanced Structural Adjustment Facility under which the IMF gives low-interest financing to help the poorest member countries facing protracted balance-of-payments problems, see: <http://www/imf.org/external/np/exr/facts/quotas.htm>.

<sup>20</sup> IMF, Press Release No. 97/59 of 17 December 1997, IMF Approves Supplemental Reserve Facility.

<sup>21</sup> IMF, Press Release No. 99/14 of 25 April 1999, IMF Tightens Defences Against Financial Contagion by Establishing Contingent Credit Lines. The Supplemental Reserve Facility is financed with resources raised through past sales of IMF-owned gold and with loans and grants provided to the IMF for this purpose, mainly by wealthy countries – see *James Raymond Vreeland, The IMF and Economic Development* (2003), 10. The Supplemental Reserve Facility provides additional short-term financing

used by Member States to resolve their balance of payments problems in a manner that is consistent with the IMF's Articles. In order to promote compliance with the conditionality, the IMF disburses its funds on a piecemeal basis (rather than in a single lump sum) and only if the country can demonstrate compliance with the IMF's conditionalities. IMF expects its financing to provide Member States "with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" as stated in IMF's Articles of Agreement, Article I(v).

The IMF executes its oversight functions through surveillance and technical assistance. Although surveillance can take several forms, the most important form is country surveillance.<sup>23</sup> In accordance with Article 4, § 3(b) of the IMF's Articles of Agreement, the IMF conducts regular consultations, normally once a year, with each member country, regarding its economic and financial policies. These consultations typically culminate in the issuance of observations and recommendations by the IMF regarding each member country's economic and financial policy performance. In addition, the IMF undertakes frequent monitoring of economic and financial factors in those countries that have borrowed funds from the IMF. The IMF also engages in technical assistance to help member countries design and implement financial policies (both monetary and fiscal), draft and review legislation, and build institutional capacity.<sup>24</sup>

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to a member country experiencing exceptional balance-of-payments difficulty because of a sudden and disruptive loss of market confidence reflected in capital outflows. The Contingent Credit Line facility provides a precautionary line of defense. This enables a member country pursuing strong economic policies to obtain financing on a short-term basis when faced by a sudden and disruptive loss of market confidence because of contagion from difficulties in other countries.

<sup>22</sup> IMF Guidelines on Conditionality, available at: <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.pdf>. Clause 11 of the Guidelines on Conditionality provides that the IMF will monitor the borrowing country's performance under agreements entered into with the IMF on the basis of prior actions, performance criteria, program and other reviews, and other variables and measures established as structural benchmarks or indicative targets.

<sup>23</sup> IMF Articles of Agreement (note 1), Art. 4 Sect. 3(a). See IMF, Public Information Notice No. 07/69 of 21 June 2007, IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies, available at: <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm>. See also *John W. Head*, Seven Deadly Sins: An Assessment of Criticisms Directed at the International Monetary Fund, *Kansas Law Review* (Kan. L. Rev.) 52 (2004), 521.

<sup>24</sup> Policy Statement on IMF Technical Assistance, 2001, available at: <http://www.imf.org/external/pubs/ft/psta/index.htm>.

### III. The General Principles of International Law Applicable to IFIs and Sovereign Debt

The 1969 Vienna Convention on the Law of Treaties (VCLT)<sup>25</sup> codifies customary international law relating to international agreements. Article 24 outlines rules governing the signing of treaties and the entry of treaties into force.<sup>26</sup> Articles 26 and 31 implement the principle of *pacta sunt servanda* as a rule for the interpretation of treaties.<sup>27</sup> *Pacta sunt servanda* means “[e]very treaty in force is binding upon the parties to it and must be performed by them in good faith.”<sup>28</sup>

Article 34 echoes the preamble of VCLT by incorporating the doctrine of “free consent,” which holds that treaties only apply to consenting States and that a treaty does not create “obligations or rights for a third State without its consent.”<sup>29</sup> Finally, Article 62 codifies the principle of *rebus sic stantibus*, which means that a fundamental change of circumstances can be a practical and legal justification for failing to perform treaty obligations.<sup>30</sup> The principle of *rebus sic stantibus* is thus an exception to the rule of *pacta sunt servanda*.

The Vienna Convention on the Law of Treaties Between States and International Organizations or Between International Organizations,<sup>31</sup> although not yet in force, makes clear that the principles of *pacta sunt servanda* and *rebus sic stantibus* are also applicable to agreements involving the IFIs.<sup>32</sup>

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<sup>25</sup> Vienna Convention on the Law of Treaties, 23 May 1969, UNTS 1155, 331.

<sup>26</sup> *Ibid.*, 338.

<sup>27</sup> *Ibid.*, 339.

<sup>28</sup> *Ibid.*, 340.

<sup>29</sup> *Ibid.*, 343.

<sup>30</sup> *Ibid.*, 347.

<sup>31</sup> The Vienna Convention on the Law of Treaties between States and International Organizations or between International Organizations, opened for signature on 21 March 1986. The Convention has not yet obtained the requisite ratification of 35 States to enter into force. The Convention is available at: [http://untreaty.un.org/ilc/texts/instruments/english/conventions/1\\_2\\_1986.pdf](http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_2_1986.pdf).

<sup>32</sup> See also *Roberto Dañino Zapata*, *Why Treaties Matter* (Opening Remarks – First Annual Conference “Interpretation Under The Vienna Convention On The Law of Treaties – 25 Years On”), 17 January 2006, available at: <http://siteresources.worldbank.org/INTLAWJUSTICE/214576-1139604306966/20817203/WhyTreatiesMatterLondon011706.pdf>.

#### IV. Interpretation of the IFIs' Articles of Agreement

As mentioned above, for IFIs such as the World Bank and the IMF, their constituent instrument is their Articles of Agreement. In the case of these two institutions, their international agreements were written at a time when the landscape of financial transactions and the profile and even the number of sister international institutions was very different from today's realities. *Ibrahim Shihata*, former General Counsel of the World Bank, explained the challenge of both preserving the vision set at the time the institution was created in 1944 and adapting to new realities:<sup>33</sup>

On the one hand, the Bank is expected at all times to adapt itself to the changing needs of the world, if only to ensure its continued relevance. On the other hand, it is extremely difficult to introduce changes through amendment of the Articles of Agreement. [...] How then can a counsel of that institution answer constant questions about the law governing Bank policies and operations which are, of course, subject to its Articles of Agreement? How does he or she identify the rules applicable to the Bank's varying transactions, which may be derived from international law or such domestic law as may be applicable, and cannot be inconsistent with the provisions of the Articles? This is perhaps the most challenging task performed by the office of the Bank's General Counsel.<sup>34</sup>

His solution was that the General Counsel can facilitate the expansion of Bank operations into new areas by issuing legal opinions, endorsed by the Executive Directors that, based on an interpretation of the Articles, clarify the conditions under which new types of operations can be undertaken.<sup>35</sup> It was through this means that the World Bank expanded its operations to support such activities as good governance, legal and judicial reform and anti-corruption programs. In his opinions on these issues, he argued that these activities were permissible because they would have such a direct, preponderant and clear effect on the country's economic development prospects that they can be treated as falling within its economic mandate as articulated in Article I of its Articles of Agreement.<sup>36</sup>

The issue of how the IFIs should respond to the sovereign debt crises posed a challenge to the institutions. Their Articles of Agreement provide no explicit

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<sup>33</sup> *Ibrahim F. I. Shihata*, The Creative Role of the Lawyer – Example: The Office of the World Bank's General Counsel, *Catholic University Law Review* 48 (1999), 1041.

<sup>34</sup> See also *Joseph Gold*, Public International Law in the International Monetary System, *Southwestern Law Journal* 38 (1984), 799.

<sup>35</sup> *Ibid.*, 1048.

<sup>36</sup> See *Ibrahim F. I. Shihata*, The World Bank and "Governance" Issues in its Borrowing Members, in: *id.* (ed.), *The World Bank in a Changing World* (1991), 53.

mandates for them to become involved in helping reduce the commercial bank debts of their members. Nevertheless, both the World Bank and the IMF were able to find legal justifications for their participation in these operations.<sup>37</sup>

Initially, this was more difficult for the World Bank. The drafting history of the World Bank's articles reveals that the possibility of the Bank renegotiating its debts to its member countries was discussed, but ultimately dropped.<sup>38</sup> The Articles of Agreement stipulate that the Bank will only provide loans and guarantees for "productive purposes"<sup>39</sup> or in "special circumstances."<sup>40</sup> The legal formula that was used to justify specific debt related assistance was based on the "special circumstances" exception. First the World Bank determined that alleviation of the debt burden was a necessary condition for a country's further sustained development and growth. Second, the World Bank's General Counsel opined that, provided a debtor country had a sound financing plan and a satisfactory adjustment program, the loans were legally justified if it could be demonstrated that the debt reduction would have a material effect on the country's investment prospects and overall development. Consequently, the Bank was able to make loans to several highly indebted middle income countries to enable them to either finance debt buybacks or to purchase collateral for the new discount and par bonds issued under the Brady plan.<sup>41</sup> On this basis, the World Bank was also able to set up a separate debt reduction facility to provide grants to the low-income (IDA-only) countries to facilitate debt reduction transactions.<sup>42</sup>

The IMF, with its mandate to help countries deal with balance of payments problems, faced an easier legal challenge. It was able to justify its debt related actions by arguing such action was permissible under Article 1(v) of its Articles of Agreement because the financing was directly linked to solving a country's balance of payments crisis.<sup>43</sup>

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<sup>37</sup> *Lous J. Ross*, International Financial Institutions' Response to Crises, American Society of International Law Proceedings 90 (1996), 428, 434 *et seq.*

<sup>38</sup> *Ibid.*

<sup>39</sup> IBRD Articles of Agreement (note 1), Art. 1.

<sup>40</sup> *Ibid.*, Art. 3 Sect. (vii): "Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development."

<sup>41</sup> See discussion of Brady Plan *infra*, note 65.

<sup>42</sup> See the World Bank website, available at: <http://go.worldbank.org/2CRHS4N500>.

<sup>43</sup> IMF Articles of Agreement (note 1). Art. 1 outlines that the "purposes of the International Monetary Fund are: [...] (v) To give confidence to members by making the

### C. IFIs and Third World Debt Crisis

While there had been third world sovereign debt crises before, the Mexican announcement in August of 1982 that it could no longer service its debts to foreign creditors set off an unprecedented crisis in developing country sovereign debt. Mexico's announcement was followed shortly by similar news from Brazil, Argentina, Bolivia, and Venezuela in Latin America, countries such as Zambia, Zaire, and Nigeria in Africa, and the Philippines in Asia. The result was that between August 1982 and October 1983, 28 countries were forced to renegotiate their debts. Collectively, these countries owed their commercial bank creditors 239 billion US Dollar, which was equal to more than 200 % of the total capital of the nine largest US banks.<sup>44</sup>

The story of the IFIs involvement in the sovereign debt crises of the past 25 years is a long and complicated tale. Due to space limitations, it is not possible to cover all aspects of it in this article.<sup>45</sup> Consequently this chapter only considers how the IFIs applied international legal principles in their actions in their operations with debtor Member States.

In this regard, it is important to note that it is difficult for the IFIs to play a neutral role in the negotiations between their Member States and their creditors. If the IFIs extend financing to the States before they reach agreement with their creditors, they would, in effect, be strengthening the Member States' negotiating position. This follows from the fact that the State would have more resources with which to meet its domestic needs and so could more easily withstand pressure to settle from their creditors. On the other hand, if the IFIs refuse to lend

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general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.”

<sup>44</sup> See, for example, *Hal S. Scott*, *International Finance: Transactions Policy and Regulation* (15th ed. 2008), 865–868. For more information on the debt of the 17 largest debtor countries, see *William R. Cline*, *International Debt Reexamined* (1995). In 1982, these 17 countries net external debt equal to 290 % of the value of their exports.

<sup>45</sup> See *Barry Eichengreen/Peter H. Lindert* (eds.), *The International Debt Crisis in Historical Perspective* (1989) (collecting essays on the crisis in relation to past debt crises); *John H. Makin*, *The Global Debt Crisis: America's Growing Involvement* (1984) (discussing the origins of the crisis and the early years of its development); *Alfred J. Watkins*, *Till Debt Do Us Part: Who Wins, Who Loses and Who Pays for the International Debt Crisis* (1986) (discussing US and Latin American perspectives on the crisis) cited in *Philip J. Power*, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings*, *Fordham Law Review* 64 (1996), 2701.

while the Member States are in arrears to their creditors, they strengthen the bargaining position of the creditors.

The Articles of the IFIs do not provide clear guidance on whether the IFIs should use their financing to help the bargaining position of either the creditor or the debtor. It is possible to make convincing arguments to support either position. As described below, at different stages of the third world debt crisis, the IFIs adopted different views on these issues.

### I. Stage 1: Enforcing *Pacta Sunt Servanda* (1982–1985)

During this stage, both the IMF and the World Bank worked to enforce the principle of *pacta sunt servanda*. They would not lend to countries in arrears to their creditors.<sup>46</sup> They insisted that the borrowers meet their current debt servicing obligations and conditioned any IFI support on Member State compliance with this obligation. In addition, they linked the availability of their support to an agreement between the Member State and its commercial bank creditors. During this stage, the typical financing arrangement included some combination of a payment by the debtor of interest payments in arrears, new money that helped members service their existing and the restructured debt obligations, and an obligation to continue meeting all debt related obligations in a timely manner.<sup>47</sup>

The rationale for this position was two-fold. First, the IMF in particular, argued that it was in everyone's interest to protect the integrity and functioning of the creditors, whose collapse could threaten the stability of the whole international financial system. This required the debtors to remain current on their debt obligations, unless these obligations were renegotiated in agreements concluded freely between the debtor and both its official and commercial creditors. In addition, the IFIs might have been concerned about the moral hazard and legal

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<sup>46</sup> James M. Boughton, *Silent Revolution: The International Monetary Fund 1979–1989* (2001), 757–764.

<sup>47</sup> IMF, *Fund Policy on Lending into Arrears to Private Creditors – Further Consideration of the Good Faith Criterion* Prepared by the International Capital Markets, Policy Development and Review and Legal Departments (In consultation with the other Departments), Approved by Gerd Häusler, Timothy Geithner and François Gianviti, 30 July 2002, available at: <http://www.imf.org/external/pubs/ft/privcred/073002.pdf> (IMF, *Fund Policy on Lending into Arrears to Private Creditors*); IMF Legal Department, *Selected Decisions and Selected Documents of the IMF, Thirtieth Issue – Arrears to Creditors and Debt Strategy*, As updated as of 30 June 2006, available at: [http://www.imf.org/external/pubs/ft/sd/index.asp?decision=3153-\(70/95\)#P511\\_163413](http://www.imf.org/external/pubs/ft/sd/index.asp?decision=3153-(70/95)#P511_163413).

precedents that would be set if countries were able, with relative impunity, to breach their obligations on their debt contracts.

During this stage, the World Bank, relying on the “special circumstances” exception in its Articles, provided financing in the form of “structural adjustment loans,” which were not linked to specific projects, but were intended to help the debtor country pay for essential imports and meet its debt servicing obligations in return for undertaking structural and social reforms.<sup>48</sup> The IMF provided the financing through its existing financing facilities. Both the IMF and the World Bank conditioned their financing on the debtor countries making such adjustments in their economic policies as tighter monetary policy, reduced budget deficits, as well as broader liberalization policies such as reducing government regulation and opening up the economy to foreign trade.<sup>49</sup> The argument was that these policies would not only help the country resolve its debt problems but restore it to a path towards sustainable development.<sup>50</sup>

The position taken by the IFIs faced substantial criticism. The conditions they attached to their financial operations were controversial, with some critics claiming that far from advancing the short or long term interests of their Member States, they actually undermined them.<sup>51</sup> Consequently, they argued, the IFIs were not conforming to their mandates. In addition, the position taken by both institutions led them each to begin expanding their scope of operations – the World Bank became increasingly involved in policy based lending. The IMF began attaching structural conditions to their financing, such as conditions related to public administration and privatization of State owned enterprises, which seemed to some critics far removed from its original macro-economic and monetary mandate.

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<sup>48</sup> *Shihata* (note 36), 8, 25.

<sup>49</sup> See *John Williamson* (ed.), *IMF Conditionality* (1983).

<sup>50</sup> *Stijn Claessens/Enrica Detragiache/Ravi Kanbur/Peter Wickham*, *Analytical Aspects of the Debt Problems of Heavily Indebted Poor Countries* (1996), available at: [http://econ.worldbank.org/files/13466\\_wps1618.pdf](http://econ.worldbank.org/files/13466_wps1618.pdf).

<sup>51</sup> There is extensive literature on this topic and it is not possible to list all of it. See e.g. *Williamson* (note 49) and *Giovanni Corina/Richard Jolly/Frances Stewart*, *Adjustment with a Human Face: Protecting the Vulnerable and Promoting Growth* (1987).

## II. Stage 2: Struggle to Balance *Pacta Sunt Servanda* and *Rebus Sic Stantibus*<sup>52</sup> (1985–1988)

On 9 October 1985, at the annual meeting of the World Bank and the IMF, U.S. Secretary of the Treasury *James A. Baker* announced a plan that he claimed would resolve the debt crisis.<sup>53</sup> *Baker's* proposal called on commercial banks to make 20 billion US Dollar in new loans to the fifteen most highly indebted Least Developed Countries (LDCs) over the course of the three years between 1986 and 1988. Under *Baker's* plan, the IMF, World Bank, and other multilateral lending institutions would contribute an additional nine billion US Dollar in new loans over the same three-year period. In exchange for these loans, *Baker* called on the debtor countries to implement austerity plans monitored by the IMF.<sup>54</sup>

Although the Baker Plan had the virtue of recognizing that the debt crisis was not merely a temporary disruption, the plan had limited success. It did not differ substantially from the rescheduling process that had developed between the banks and the debtor countries during the first three years of the crisis. Moreover, net lending to the debtor countries under the Baker Plan did not approach the 29 billion US Dollar envisioned.<sup>55</sup>

Both debtors and creditors were less than enthusiastic about the Baker Plan. Creditors were concerned that they were entering an endless cycle of rescheduling and bridge loan requests. The debtor countries also began to realize that by incurring new debt to keep current their interest payments on old loans they were merely increasing their debt burden.<sup>56</sup>

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<sup>52</sup> There is such a large amount of literature on this topic that it is not possible to list all of it. See generally *Eichengreen/Lindert* (note 45); *Makin* (note 45); *Watkins* (note 45).

<sup>53</sup> See Statement by the Honorable *James A. Baker, III*, Secretary of the Treasury of the United States, before the Joint Annual Meeting of the IMF and World Bank of 8 October 1985 in Seoul, South Korea, reprinted in: U.S. Department of Treasury News of 8 October 1985 and International Bank for Reconstruction and Development, Annual Meeting Summary Proceedings (1985), 205–214.

<sup>54</sup> However, as neither side cooperated, the plan was short-lived, *Boughton* (note 46), 417.

<sup>55</sup> *Boughton* (note 46), 427 *et seq.* Also see *Alberto. G. Santos*, Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors, *New York University Law Review* 66 (1991), 66, 77.

<sup>56</sup> *Enrique R. Carrasco*, Chile, Its Foreign Commercial Bank Creditors and Its Vulnerable Groups: An Assessment of the Cooperative Case-by Case Approach to the Debt Crisis, *Law and Policy in International Business* (Law & Pol'y Int'l Bus.) 24 (1993), 286.

The result was that the IFIs, as well as many creditors and debtors began to recognize that it was not feasible to enforce the original debt obligations. In other words they began, at least implicitly, to recognize that the application of the *pacta sunt servanda* principle would have to be modified by *rebus sic stantibus*. This did not mean that they were ready yet to excuse borrowers from performing their debt obligations. However, it did mean that they were willing to offer them more generous rescheduling options and even to apply the principle of keeping debts current more flexibly. It is important to note however that the IFIs, in their role as creditors did not change their position from enforcing the debt as originally agreed, *i.e.* enforcing *pacta sunt servanda*.

During this period, the IFIs began to suggest that the problems of the debtor countries were not only caused by their high levels of debt but also by problems in their governance arrangements.<sup>57</sup> Consequently, they slowly began to expand the conditions attached to their financing to include governance reforms in their Member States.

This meant that the World Bank was beginning to include issues which are not self-evidently “economic,” such as the environment, governance, and gender, in its scope of operations.<sup>58</sup> This, in turn, began to raise concerns about the precise meaning of the political prohibition in its Articles of Agreement. In particular, it raised questions about how the World Bank was interpreting the requirement that it should base its decisions on “economic considerations” and should not take the “political character” of its borrowers into account. These terms are not defined in the Bank’s Articles. However, the General Counsel addressed the matter in his Legal Opinion on Governance, and determined that any issue that has “direct and obvious economic effects” could be treated as inside the mandate of the Bank even if it also had clear political dimensions.<sup>59</sup> This position helped stimulate interest in the Bank’s responsibilities in regard to human rights.<sup>60</sup>

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<sup>57</sup> See, for example, World Bank, *Governance: The World Bank Experience* (1994); World Bank, *Governance and Development* (1992).

<sup>58</sup> See *Daniel Bradlow*, *The World Bank, the I.M.F. and Human Rights*, *Transnational Law & Contemporary Problems* (Transnat’l L. & Contemp. Probs.) 6 (1996), 47.

<sup>59</sup> *Shihata* (note 36), 84.

<sup>60</sup> Starting in 1998, the Bank, issued public statements about the relationship between development and human rights, See *Human Rights and Development: The Role of the World Bank* (1998); *World Development Report 2006, Equity and Development* (2006). On 27 January 2007, the Senior Vice-President and General Counsel, *Roberto Dañino*, issued “Legal Opinion on Human Rights and the Work of the World Bank,” (Dañino

It also laid the foundation for a substantial later expansion of the Bank's mandate to the point where it began encroaching into the areas of "jurisdiction" of the IMF and other international organizations.

The IMF's Articles do not have an explicit political prohibition. Instead, it is merely required to take the domestic social and political conditions in its Member States into account in its work in the country. This requirement has been interpreted as amounting to a political prohibition. However, it has not prevented the IMF from addressing governance issues in its Member States when it deems it necessary. This position, over time, has facilitated a similar broad expansion in the IMF's scope of operations, so that it too is now encroaching into the "jurisdiction" of the World Bank and other international organizations.

The IFIs "mission creep" has attracted criticisms.<sup>61</sup> In fact, some of these critiques have accused the IFIs of not acting lawfully within the parameters of their charters. For example, these critics claim that the World Bank has expanded its operations into activities that can be seen as "political" in the sense that they are not primarily economic in focus – such as anti-corruption, judicial reform, gender issues. This has resulted, they claim, in an expansion of the World Bank's purposes and operations into areas in which it has no authority under its original charters. According to its critics, these activities have resulted in these institutions acting *ultra vires*. It has also been argued that it undermined their efficacy.<sup>62</sup> Similarly, the IMF's critics contend that the expansion of the IMF's operations into such activities as supporting "governance" issues and

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Opinion). It indicates that human rights may constitute legitimate considerations for the Bank where they have economic ramifications or impacts, and it confirms the facilitative role the Bank may play in supporting its members fulfill their human rights obligations. See: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTSITETOOLS/0,,contentMDK:20749693~pagePK:98400~piPK:98424~theSitePK:95474,00.html>.

<sup>61</sup> See *John W. Head*, Law and Policy in International Financial Institutions: The Changing Role of Law in the IMF and the Multilateral Development Banks, *Kansas Journal of Law & Public Policy* 17 (2007), 194; *Daniel Bradlow*, Should the International Financial Institutions Play a Role in the Implementation and Enforcement of International Humanitarian Law?, *Kan. L. Rev.* 50 (2002), 695 and *Daniel Bradlow/Claudio Grossman*, Limited Mandates and Intertwined Problems: A New Challenge for the World Bank and the IMF, *Human Rights Quarterly* 17 (1995), 411.

<sup>62</sup> See *Head* (note 61), 206; *Robert Hockett*, From Macro to Micro to "Mission Creep:" Defending the IMF's Emerging Concern with the Infrastructural Prerequisites to Global Financial Stability, *Columbia Journal of Transnational Law* 41 (2002), 153, 177–178.

structural reform has extended its operations into areas in which it has questionable authority to act.<sup>63</sup>

### III. Stage 3: The “Triumph” of *Rebus Sic Stantibus* (1988–2007)

By gradually setting aside loan-loss reserves, the banks had, by 1989, gained the ability to write off large portions of their sovereign loans, and to withstand pressures to lend new money. Thus, the sovereign debt no longer presented such a severe systemic threat to the international financial system. Equally importantly, it had become clear that the most heavily indebted countries would never regain financial stability without some form of debt and debt service reduction. Thus, by 1989 the balance of concerns for the IFIs had begun to shift from a concern with the survival of the creditors to a concern about the future of the debtors and their ability to both pay back their debts and develop sustainably.

In response to these developments, in March 1989, then US Secretary of the Treasury *Nicholas Brady* announced a new initiative designed to encourage banks voluntarily to reduce the debt burdens of LDC debtors and securitize their sovereign loans by converting them into bonds, known as Brady bonds.<sup>64</sup> One consequence of the Brady plan was that it promoted securitization of third world debt instruments, which helped middle income countries (MICs) access financial markets. It also helped contribute to the MICs reduced need for fund-

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<sup>63</sup> For a different perspective see *Hockett* (note 62), explaining (1) why it is appropriate for the IMF to adapt to changing circumstances in general, and (2) why the specific direction that the IMF has taken in expanding the scope of its attention is both legal and necessary. The IMF’s charter vests in the IMF itself all power to interpret its own charter – a matter that raises “a nearly irrebuttable presumption in favor of formal legality” of IMF action.

<sup>64</sup> See, for example, *Nicholas F. Brady*, Remarks to a Third World Debt Conference, Dep’t of State Bull., May 1989, 53–56; *Lee C. Buchheit*, The Background to Brady’s Initiative, *International Financial Law Review*, 29 April 1990, 30; generally *David Greene* in: Richard O’Brien/Tapan Datta (eds.), *International Economics and Financial Markets – the Amex Bank Review Prize Essays* (1989), 103 (discussing debt crisis in Africa in 1980s). See also *Power* (note 45), 2714; *James T. Gathii*, The Sanctity of Sovereign Loan Contracts and its Origins in Enforcement Litigation, *George Washington International Law Review* 38 (2006), 251 and *John Calverley/Ingrid Iversen*, Banks and the Brady Initiative, in: *Stephany Griffith-Jones* (ed.), *Third World Debt – Managing the Consequences* (1989), 129.

ing from the IFIs, which, in turn, has helped create an existential crisis for the institutions, particularly the IMF.

Another consequence was that it contributed to changes in the IMF's policy concerning lending to debtors in arrears. By the late 1980s banks became increasingly reluctant to provide additional financing to their debtor States, which caused growing delays in Fund support for adjustment programs. The Fund's policy also resulted in providing creditors with excessive leverage over debtors, as it gave them a *de facto* veto over Fund arrangements. In 1989 the Fund modified its arrears policy to tolerate temporary arrears to commercial banks in order to remove the banks' *de facto* veto over Fund support.<sup>65</sup>

This policy was expanded in 1999 to encompass arrears on bonds and other nonbank forms of financing from private creditors.<sup>66</sup> IMF Directors agreed that lending into arrears to private creditors (including bondholders and commercial banks) should be on a case-by-case basis and only where: (i) prompt IMF support is considered essential for the successful implementation of the member's adjustment program; and (ii) the member is pursuing appropriate policies and is making a good faith effort<sup>67</sup> to reach a collaborative agreement with its creditors. In 2002, the IMF Directors confirmed that lending into sovereign arrears to private creditors continued to be a useful tool.<sup>68</sup> There have been subsequent Board discussions of the policy but it has not been changed in any significant way until the present time.

It is important to note that in legal terms, the IMF's policy of lending into arrears amounts to recognition that it should use its leverage to help its Member States uphold the principle of *rebus sic stantibus* in their negotiations with their creditors. In these circumstances, the principle, while not resulting in a complete excuse for non-performance, at least constitutes a legal and principled basis for providing some relief to the borrower because of the changed circumstances surrounding its debt commitments.

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<sup>65</sup> See The Acting Chairman's Summing Up on Fund Policy on Arrears to Private Creditors – Further Considerations (EBM 99/64, 6/14/99) cited in: IMF, Fund Policy on Lending into Arrears to Private Creditors (note 47).

<sup>66</sup> *Ibid.*

<sup>67</sup> *Ibid.*

<sup>68</sup> The Acting Chair's Summing Up-Fund Policy on Lending into Arrears to Private Creditors-Further Consideration of the Good Faith Criterion Executive Board Meeting 02/92, 4 September 2002.

*1. Different Treatment for the Debts of LICs and MICs*

## a) The HIPC Initiative and its Aftermath

One consequence of the IFIs policy for dealing with developing country debt began to become clearer during this third period – the growing importance of the IFIs as creditors of low income country debtors (LICs). This had occurred because as other creditors reduced their exposure to the LICs, the IFIs both in relative and absolute terms became larger and more important creditors. This eventually made it extremely difficult for these countries to resolve their debt crises without the IFIs participating as creditors in any debt renegotiation scheme.

By 1996, it had become clear that many low income countries, despite their hard efforts to implement the policies advocated by the IFIs, were unable to develop unless their debt burden was reduced. To respond to this situation, the key creditor countries announced the creation of the Highly Indebted Poor Country (HIPC) Initiative. This initiative, designed to reduce the debt burden of qualifying countries, was enhanced in 1999 as an outcome of a comprehensive review by IDA and the IMF, including public consultations. The HIPC Initiative offered the prospect of debt forgiveness on official credits and commercial credits to a group of 33 low income countries who could show that they were complying with the policy conditions of the IFIs but were still unable to reduce their debt below certain key indicator levels.<sup>69</sup>

The original HIPC initiative was not particularly generous because it required the debtor State to show a three year track record of compliance with IFIs policies before it could qualify for debt relief. Thereafter, another indeterminate period of compliance followed before the debtor States actually obtained this relief. The 1999 revisions reduced the debt ratio thresholds, which enabled a broader group of countries to qualify for larger volumes of debt relief. Moreover, a number of creditors started to provide earlier assistance to qualifying countries, thereby providing incentives to speed up reforms.<sup>70</sup> The IFI role

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<sup>69</sup> See the IMF website at: <http://www.imf.org/external/np/exr/facts/hipc.htm> and the World Bank website at: <http://go.worldbank.org/85B908KVE0>.

<sup>70</sup> See World Bank web site at: <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/>.html. See also Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation, Prepared by the Staffs of IDA and IMF, 27 September 2007.

during in these initiatives was both advisory and financial – they continued to provide new financial support.

The HIPC Initiative raised an important legal concern for the IFIs. Until this initiative, they had always claimed that they did not reschedule debt and their position as “preferred creditors” had always been respected by the other creditors. They had always justified this position by arguing that they continued to lend to their Member States even after all other creditors were refusing the country credit.

The position of the IFIs became untenable when it became clear that the HIPC initiative was insufficient and that a broader debt relief initiative was needed. This resulted in November 2005 in an initiative called the Multi-Lateral Debt Initiative (MDRI).<sup>71</sup> The MDRI provides HIPC’s new breathing space to strengthen their financial position and support their efforts to reach the Millennium Development Goals (MDGs). It also provides for the possibility of debt relief from the IFIs themselves.<sup>72</sup> Qualifying countries may receive MDRI relief financed from bilateral contributions to the PRGF Trust Subsidy Account, subject to the consent of contributors and other applicable requirements.<sup>73</sup>

Most participating IFIs have provided debt relief under the HIPC Initiative and the MDRI. Official creditors continue to provide debt relief in line with their original HIPC commitments. These creditors have also provided debt relief on a bilateral basis beyond that committed under the HIPC Initiative.

Commercial creditors’ lawsuits against HIPC’s have presented a challenge to the implementation of the HIPC Initiative. In response to these problems, the World Bank and the IMF have taken the position of encouraging broad and equitable participation by all creditors in the HIPC Initiative. According to a joint WB-IMF report, commercial creditors’ lawsuits against HIPC’s presented, and in some cases still present, a big challenge to the implementation of the HIPC Initiative. In response to these problems, the international community has intensified its efforts to discourage litigation against HIPC’s, and the World Bank and

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<sup>71</sup> See The Acting Chair’s Summing Up – Multilateral Debt Relief Initiative and Exogenous Shocks Facility – Proposed Decisions, available at: <http://www.imf.org/external/np/pp/eng/2005/111605.htm>.

<sup>72</sup> See The G8 Debt Relief Proposal: Preliminary Costs and Issues (IDA SecM2005–0414), available at: <http://siteresources.worldbank.org/IDA/Resources/G8DebtPaperSept05.pdf>.

<sup>73</sup> See the IMF website at: <http://www.imf.org/external/np/exr/facts/prgf.htm>.

the IMF have continued their intense efforts to encourage broad and equitable participation by all creditors in the HIPC Initiative.<sup>74</sup>

Lawsuits against HIPCs have been filed mainly in London, Paris, and New York with nine, seven, and six cases respectively. Another fifteen legal disputes have been filed in local courts in HIPC countries.<sup>75</sup> There are also international commercial arbitration proceedings involving four HIPCs (Cameroon, the Democratic Republic of the Congo, Republic of Congo, and São Tomé and Príncipe).

Litigating creditors have generally won lawsuits against HIPCs. Of the 44 current cases, 26 creditors have obtained court judgments in their favor against seven HIPCs (Cameroon, the Democratic Republic of the Congo, Republic of Congo, Nicaragua, Sierra Leone, Uganda, and Zambia), amounting to about 1 billion US Dollar. Sierra Leone, Uganda, and Zambia have already paid a cumulative 30 million US Dollar to some of their litigating creditors, including through out-of-court settlements. In the case of the Republic of Congo, creditors have obtained at least five enforceable court judgments against the country and are seeking to enforce them in multiple jurisdictions. Fourteen lawsuits (against Cameroon, Guyana, Honduras, Sierra Leone, and Zambia) are still pending.<sup>76</sup>

#### b) Treatment of the MICs

During the 1990s, the difference in the situation of low income and medium income debtor countries became much starker. Medium income countries (MICs), particularly those known as emerging market countries, found their financing options expanding as they were able to tap international capital markets and so gain access to new groups of commercial creditors such as insurance companies, mutual funds and hedge funds. The result was that for many of these countries borrowing from the IFIs, with their perceived cumbersome procedures and more stringent borrowing conditions, became less attractive. The major benefit for them of the IFIs was that they offered the countries a “stamp

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<sup>74</sup> See on vulture fund litigation against HIPCs: International Development Association and International Monetary Fund Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation, Approved by *Danny Leipziger* and *Mark Allen*, 21 August 2006, available at: <http://www.imf.org/external/np/pp/eng/2006/082106.pdf>.

<sup>75</sup> *Ibid.*

<sup>76</sup> *Ibid.*

of approval” that indicated to other potential sources of funds that the countries were following suitable policies and were acceptable credit risks.

The IFIs played a critical and influential role in the MICs during the 1990s and early 2000s. They helped these countries access the funding that was now available to them from the international financial markets by providing them advice on how to interact with these creditors and by communicating to creditors their confidence in the MICs as debtors. They also encouraged the MICs to adopt policies that would integrate themselves into the international financial market, thus making it easier for external creditors to invest in their financial institutions and financial instruments.

The consequences of this policy were exposed by the Asian financial crisis in the mid-1990s and in the subsequent crises in such countries as Russia, Brazil and Argentina. These crises not only raised questions about the competence of the IFIs, particularly the IMF, as advisors to the MICs but also about their financing roles. The latter was challenged because it was revealed that the IMF was attaching large numbers of conditions to its financing and that many of these conditions seemed connected to promoting a particular policy agenda. The reaction in many MICs was to work to reduce their exposure to the IMF, and to develop such large reserves that they could protect themselves in times of financial difficulty.

The IFIs actions in this third stage created a legal challenge for the IFIs, which is still not fully resolved. The first aspect of this challenge, discussed above, is the scope of operations of the IFIs and concern that they may be exceeding their mandates. This issue raises questions about the interpretation of their Articles of Agreements. In the case of the IMF, this means interpreting its international monetary mandate as set out in Article 1 of its Articles of Agreement. For the WB, it means both interpreting the political prohibition in its charter and deciding the amount of policy based lending that is permissible under the “special circumstance” exception to its project based lending requirement. The issue also raises questions about what happens when the IFI is exceeding the scope of its mandate. While in principal the IFIs should be responsible for any adverse effects of any operations that exceed the scope of its mandate, it is not clear if or how they can be held accountable. This in turn raises concerns about international organizational responsibility and the limits of organizational accountability.

Another issue that arose from the MIC debt problems was that it highlighted the complexities of addressing debt crises in which the major form of debt was securities, particularly bearer securities. In fact, it was another indication that the international financial system had moved beyond being a system in which the primary commercial lenders of international development financing were banks to one in which the primary form of financing was securitized debt instruments that could be held by almost any institution or any individual. This complicated situation briefly stimulated debate about what reforms were needed to promote more effective management of sovereign debt.

## 2. Search for New Approaches

### a) The Case of Iraq

Following the defeat of *Saddam Hussein*, an important issue relating to the future of Iraq was what to do about its sovereign debt. US diplomatic efforts persuaded Paris Club members to agree to forgive 80 % of debts owed to them by Iraq. The US based its arguments on the concept of “odious debt.”<sup>77</sup> These arguments were inconsistent with the longstanding US assertion that sovereign debt agreements are binding under international law, regardless of how the proceeds are used (through the application of *pacta sunt servanda*). When this news became public, one newspaper noted: “Some developing country policy-makers and debt-relief campaign groups have contrasted the generous and swift relief being considered for Iraq with slow progress in reducing the debt of highly indebted African economies.”<sup>78</sup> At the same time, legal scholars pointed out that the legal principles of odious debt, and *rebus sic stantibus*, as well as the examples of the treatment of sovereign debts during the German unification and the succession of Yugoslavia, and African debt incurred during the Cold War, support the argument that current Iraqi debt should be discharged.<sup>79</sup>

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<sup>77</sup> On 21 November 2004, *Jean-Pierre Jouyet*, Paris Club president, said that the agreement urged by the US foresaw 80 % of Iraq’s debts to the Paris Club being canceled in three stages: 30 % immediately, a further 30 % in 2005, and 20 % in 2008. See *Charles Seavey*, *The Anomalous Lack of an International Bankruptcy Court*, *Berkeley Journal of International Law* 24 (2006), 503.

<sup>78</sup> *Id.* citing *Ralph Atkins/Andrew Balls*, *Snow Praises Berlin for Iraq Debt Pact at G20 Summit*, *Financial Times* of 20 November 2004, 7.

<sup>79</sup> Based on *Kevin H. Anderson*, *International Law and State Succession: A Solution to the Iraqi Debt Crisis?*, *Utah Law Review* 2 (2005), 401.

However, convincing (or not) one finds the justification for providing such debt relief, it establishes a precedent that can be used to demand substantial debt relief for other countries in difficulty. As *James Wolfensohn*, the former president of the World Bank, noted: “America’s determination to write off Saddam Hussein’s [...] debt mountain has opened the door to a more generous deal for the most impoverished countries in Africa.”<sup>80</sup>

#### b) Sovereign Debt Renegotiation Mechanism (SDRM)

In September 2002, the International Monetary and Financial Committee (IMFC) requested the IMF to develop a concrete SDRM proposal for consideration at the April 2003 Spring meetings. The proposal was envisioned as “both a crisis resolution and a crisis mitigation device that could help limit sovereign debt crises if triggered early enough to prevent the severe economic dislocation that often occurs when countries resist dealing with their debt problem.”<sup>81</sup> The proposal aimed to provide a legal framework for collective creditor negotiations, with several characteristics:

1. Agreement by a supermajority of creditors to a debt restructuring agreement that would be binding on all creditors covered by the SDRM; minority creditors would be prevented from blocking such agreements.
2. Mechanisms to prevent disruptive legal action by creditors while negotiations are under way.
3. Assurances to creditors that debtors will negotiate in good faith and pursue policies that help protect their claims and limit the dislocation in the economy.
4. Some form of debtor-driven protection including restructuring of new private financing in order to facilitate the debtor’s ongoing economic activity.
5. A dispute resolution forum to oversee the process – verify claims, ensure the integrity of the voting process, adjudicate possible disputes, and certify the debt restructuring agreement.<sup>82</sup>

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<sup>80</sup> *Larry Elliot/Charlotte Denny*, World Bank Seizes on Iraq Debt Deal, *Guardian* (London) of 20 April 2004, 21.

<sup>81</sup> *Jack Boorman*, Annual Midwinter Strategic Conference of the Banker’s Association for Finance and Trade Speech, Washington, 28–29 January 2003, available at: <http://www.imf.org/external/pubs/ft/survey/2003/021703.pdf>.

<sup>82</sup> IMF survey of 2003, available at: <http://www.imf.org/external/pubs/ft/survey/2003/021703.pdf>.

The proposal has not yet been implemented, in spite of the fact that the international financial system lacks a strong legal framework for the predictable and orderly restructuring of sovereign debt, to reduce the high cost of default.<sup>83</sup>

### c) International Investment Arbitration

The announcement by the Global Committee of Argentina Bondholders (GCAB)<sup>84</sup> that it may initiate international investment arbitration against its debtors could potentially create a new precedent in sovereign debt restructurings. This announcement followed the introduction of the Argentine law prohibiting the government from reopening the debt exchange or engaging in private or judicial settlements with creditors that did not accept its restructuring offer which involved significant losses for the creditors. GCAB contends that bondholders should be able to rely on the bilateral investment treaties (BITs) between Argentina and a number of G-20 countries. They further argue that the new Argentine proposal constitutes, under the BITs, an expropriation of bondholders' claims. Consequently, pursuant to these BITs, they can bring investment arbitrations, under the rules of the International Center for the Settlement of Investment Disputes (ICSID).<sup>85</sup> However, given the unprecedented nature of these actions, their outcome is uncertain.

## **D. Evaluating the IFIs Conduct and International Law**

There are three dimensions to the question of the IFIs, international law and their debt operations. They are the compliance of the IFIs with their customary international law obligations, their interpretation and implementation of their mandates, and their accountability for their actions. Each of these will briefly be considered in this section.

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<sup>83</sup> For a discussion on the key impediments that have prevented the establishment of the SDRM, see *Seavey* (note 79).

<sup>84</sup> Available at: <http://www.tfargentina.it/download/GCAB%20-%20AFJP%20Press%20Release%20-%2010-13-2004%20Final.pdf> or <http://fpc.state.gov/documents/organization/39301.pdf>.

<sup>85</sup> Argentina is already a defendant in over 30 investments arbitrations before ICSID tribunals mainly brought by foreign investors in the utility sector. See <http://www.imf.org/external/np/pp/eng/2005/041205.pdf>.

### I. Customary International Law

As has been discussed above, it is difficult to identify many principles that are applicable as customary international law to the IFIs. For example, while there may be general obligations requiring them to respect human rights, it is difficult to claim that this obligation has great specificity. Similarly, it is even harder to identify any customary environmental law principles that can be applied to the IFIs. Thus, in the final analysis the only customary international legal principles that are clearly applicable to the IFIs in their dealings with sovereign debt issues are *pacta sunt servanda* and *rebus sic stantibus*.

It is clear that the IFIs have been taking both these principles into account, including their good faith requirement, in their management of the debt problems of their Member States. As a result, at different times they have emphasized one or the other of these principles in the role that they have played during the debt crises of their Member States. They have emphasized *pacta sunt servanda* when they believe that their primary obligation is to help enforce debt obligations and uphold the sanctity of contract for the sake of the functioning of the international financial system. On the other hand, they have been willing to champion a version of *rebus sic stantibus* (*i.e.* debt forgiveness and lending into arrears) when they have seen that the debtor countries need substantial debt relief in order to meet their obligations to their own citizens. Thus, regardless of whether or not one agrees with how they have applied these principles, it is clear that the IFIs have met their customary international legal obligations during their engagement with their Member States in debt difficulty over the past 25 years.

### II. Articles of Agreement

The responsibility of the IFIs towards overcoming the debt problems of their Member States is also based on their mandates, as defined in their Articles of Agreements. In this regard, it is important to note that according to the VCLT, the Articles should be interpreted according to their purpose, the context in which they operate and the ordinary meaning of their words.<sup>86</sup> As has been discussed above, the IFIs Articles of Agreement are drafted in exquisitely ambiguous language that provides them with a reasonable degree of flexibility in

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<sup>86</sup> VCLT (note 25), Art. 31.

regard to its interpretation – although as the comments cited above from *Shihata* suggest this flexibility has its limits. In light of these two observations, we can conclude that, in brief, the mandate of the IFIs in regard to sovereign debt is to help debtor countries overcome their debt crises in ways that are not destructive of national or international prosperity, that do not undermine the international monetary and financial system and that contribute to the long term growth and development of these countries. The issue of IFI compliance with these mandates raises some important legal issues, as explained below.

First is the problem of mission creep. As was discussed above, the IFIs have expanded the scope of their missions considerably since 1982 and have begun to deal with issues of governance and other social matters that call into question the World Bank's compliance with its political prohibition and the IMF's compliance with its mandate not to interfere in the domestic social affairs of its Member States. The resulting criticisms of the IMF's or WB's "mission creep" can be divided into two groups. First, there are those who criticize the Bretton Woods twins for the way they have gone about expanding their mission, rather than criticizing the fact that they have chosen to do so. This is a criticism about the direction and content of the mission creep. Some of these critics have contended mission creep feeds a tendency "to politicize the two organizations in ways that will ultimately undermine their efficacy."<sup>87</sup> Defenders of the World Bank and the IMF counter the first argument by stating that the mandate of these institutions is sufficiently broad to allow the arrangements that they have ultimately instituted.<sup>88</sup> For them, the very vagueness of the mandate of the World Bank and the IMF as contained in their Articles of Agreement provides the necessary support to their arguments. However, these defenders have been unable to clearly articulate what limits the political constraints in their Articles in fact impose on the IFIs or how they should deal with the jurisdictional conflicts with other international organizations that are created by their mission creep.

The second group of mission creep critics focuses on the content of the IFIs expanded mission, and how it is implemented through the conditionality attached to their financing. These conditions now include issues such as legal and judicial reform, gender issues, decentralization, and relations between the State and the

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<sup>87</sup> *Head* (note 61).

<sup>88</sup> *Head* (note 61) citing *Hockett* (note 62).

market.<sup>89</sup> These critics argue that such direct engagement with long-term structural issues raises two important concerns relating to the compliance of the IFIs with their obligations under their mandates. First, they contend that it raises questions about the obligations of the IFIs to respect international human rights and environmental law and the obligations of their Member States in this regard. While acknowledging that the IFIs are not signatories to the key international or regional treaties on this subject, these critics maintain that as subjects of international law, they at least have an obligation to ensure that their financing operations and the conditions attached thereto do not undermine their Member States' ability to comply with own international legal commitments. Some of these critics question the ability of the IFIs, given their specialized mandates, to assess these commitments and ensure compliance with them. They also contend that the IFIs may fail to meet even this limited international legal obligation when they support complex and controversial policies and projects that involve, for example, forced resettlement of people or environmental degradation.

Over the years, the World Bank has recognized that there is some merit in this criticism and has even tried to address some of these points. First, it has adopted a set of "safeguard policies" to ensure that there is more effective treatment of social and environmental issues in its operations. In the case of the environmental policies, the World Bank has explicitly noted that it will act to ensure that its Member States comply with their international legal commitments. It has also established the Inspection Panel as an independent body reporting directly to the Board, to evaluate compliance with these policies.<sup>90</sup> The World Bank has also begun to address the question of its human rights responsibilities in its operations.<sup>91</sup> The IMF however has not been as forthcoming as the World Bank.<sup>92</sup>

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<sup>89</sup> *Id.*, citing *Mary C. Tsai*, Globalisation and Conditionality: Two Sides of the Sovereignty Coin, *Law & Pol'y Int'l Bus.* 31 (2000), 1317, 1318, 1329 and *Saladin Al-Jurf*, Good Governance and Transparency: Their Impact on Development, *Transnat'l L. & Contemp. Probs.* 9 (1999), 193, 206.

<sup>90</sup> The Inspection Panel was established by the Executive Directors of the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) on 22 September 1993. See <http://web.worldbank.org/WBSITE/EXTERNAL/EXTINSPECTIONPANEL/>.html. Also see discussion about accountability, *infra*, notes 97 to 102.

<sup>91</sup> See, for example, Dañino Opinion (note 60).

<sup>92</sup> See *Francois Gianviti*, Economic, Social and Cultural Human Rights and the International Monetary Fund (2002), available at: <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/gianv3.pdf>.

A second set of legal issues relates to the meaning of the political prohibition in the Articles of the World Bank. Interestingly, the Articles do not define either what “political” or “economic” means for these purposes. *Ibrahim Shihata*, the former General Counsel attempted to give some meaning to these terms in his legal opinion on governance. However, his explanation of which issues are sufficiently “economic” to be considered part of the Bank’s mandate is too general to be fully useful.<sup>93</sup> The result, in effect, is to give the management and staff of the Bank the discretion to decide this issue. This in turn makes it extremely difficult for outsiders to understand the basis for their decisions and results in a perception that the political prohibition is applied in an arbitrary way.

The situation in the IMF in some ways is more complicated because there is no explicit political prohibition. It has merely interpreted its Articles, which admonish it, to pay due regard to the domestic social conditions of its members, as amounting to a prohibition against taking political considerations into account in its operations.<sup>94</sup> It is very hard for any outsider to understand either how a macro-economically focused institution can do its job without taking political considerations into account or how in fact the IMF applies this prohibition. This again results in it being accused of acting in a relatively arbitrary manner in this regard.

### III. Accountability

It is important to note that as the First Report of the ILA’s Committee of Accountability of International Organizations states: “Accountability is not a notion which, for the sake of its operationality, is or has to be viewed as monolithic, calling for uniform and indiscriminate application. Such rigidity would not survive the complexities of international reality.”<sup>95</sup> Instead, accountability is multifaceted, with various degrees of consequences ranging from oversight, monitoring, and evaluation processes to censorship or other forms of sanctions

<sup>93</sup> *Ibrahim Shihata*, Prohibition of Political Activities in the Bank’s Work: Legal Opinion by the Senior Vice President & General Counsel, 12 July 1995 (World Bank).

<sup>94</sup> IMF Articles of Agreement (note 1), Art. 4 Sect. 3(b): “These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.”

<sup>95</sup> Report of the International Law Association Committee on Accountability of International Organizations, available at: <http://www.ilahq.org/pdf/Accountability/Final%20Report%202004.pdf> (one of the authors, *Daniel Bradlow*, was a member of the committee).

to the attribution of legal liability for injuries, resulting in binding remedial action.<sup>96</sup>

The expansion of the mission of the IFIs has raised concerns about their accountability in two regards. First, given their increased engagement with the policy-making and governance structures of those Member States that use their services, there is a concern about how easily some of the Member States are able to make their concerns about IFIs policies heard in the Boards of Executive Directors of the IFIs. In this sense, the literature has witnessed an on-going debate over voting rights within IFIs.<sup>97</sup>

Second, the fact that the IFIs are playing this expanded role in their member countries means that they come into more direct contact with citizens and other non-state actors. However, there has historically only been indirect and limited ways in which these non-state actors and private citizens can seek to hold the IFIs accountable for their actions. Legally, the only route was for them to advocate to their governments to hold the IFIs accountable for the harm caused to their citizens. In 1994, the World Bank altered this situation when it created the World Bank Inspection Panel.<sup>98</sup> This example, subsequently copied in all regional development banks and the IFC, has created a new mechanism through which private actors can hold IFIs accountable.<sup>99</sup> In particular, private actors

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<sup>96</sup> For critical view of this report see *Ige F. Dekker*, Making sense of accountability in international institutional law, *Netherlands Yearbook of International Law* 36 (2005), 83.

<sup>97</sup> *Ariel Buira* (ed.), *Challenges to the World Bank and the IMF: Developing Country Perspectives* (2003), 55–90 and *Daniel Bradlow*, *The Governance of the IMF: The Need for Comprehensive Reform* (prepared for G24 Technical Committee), available at: [www.g24.org/brad0906.pdf](http://www.g24.org/brad0906.pdf).

<sup>98</sup> See IBRD Resolution 93–10 and IDA Resolution 93–6, The World Bank Inspection Panel was adopted by the Bank's Board of Executive Directors on 22 September 1993; For information on the creation of the Inspection Panel, see *Ibrahim F. I. Shihata*, *The World Bank Inspection Panel* (1994); *Daniel Bradlow*, *International Organizations and Private Complainants: The Case of the World Bank Inspection Panel*, *Virginia Journal of International Law* 34 (1994), 553; *Daniel Bradlow/Sabine Schlemmer-Schulte*, *The World Bank's New Inspection Panel: A Constructive Step in the Transformation of the International Legal Order*, *Zeitschrift für Ausländisches Öffentliches Recht und Völkerrecht* 54 (1994), 392 and *Eisuke Suzuki/Suresh Nanwani*, *Responsibility of International Organizations: The Accountability Mechanisms of Multilateral Development Banks*, *Michigan Journal of International Law* 27 (2005), 177.

<sup>99</sup> For a comparative study of these mechanisms, see *Daniel Bradlow*, *Private Complainants and International Organizations: A Comparative Study of the Independent Inspection Mechanisms in International Financial Institutions*, *Georgetown Journal of International Law* 36 (2005), 403.

who believe that they have been harmed or threatened with harm because of the failure of the Bank to comply with its own policies and procedures in an operation in their country, can petition the Panel to investigate the project and make findings to the Board of the Bank about the staff and management's compliance with the applicable policies. These mechanisms are relatively new and the oldest, the World Bank Inspection, has only had 52 petitions. Nevertheless, it would seem that these mechanisms, despite concerns about their efficacy, have resulted in increased accountability for these institutions.<sup>100</sup>

### **E. Conclusion**

The world today is very different from the one for which the World Bank and IMF were created. Powerful political, social, environmental and economic forces are changing the way in which business is done in both developing and rich countries and are forcing all actors to adapt and adopt this new reality.<sup>101</sup>

In such a complex environment, it is a challenge for the IFIs to meet their substantive mandates of overseeing the international monetary system and promoting development in their member countries. It is even more difficult for them to do so in the abnormal conditions created by a sovereign debt crisis in a Member State or group of Member States. When to these challenges are added the requirement of complying with international legal requirements as non-specific as those arising from general principles of customary international law and from flexibly drafted Articles of Agreement, it is not surprising that the IFIs have a mixed record for compliance with their international legal obligations.

They are conforming with their most unambiguous customary international legal obligations and, at least to a meaningful extent, with their obligations to provide those affected by their actions with some form of accountability. However, they have been less successful in fully complying with the requirements of their flexible Articles. Their failure to adequately address the consequences of

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<sup>100</sup> See *Dana Clark et al.* (eds.), *Demanding Accountability: Civil Society Claims and the World Bank Inspection Panel* (2003) and *Accountability at the World Bank – The Inspection Panel: 10 Years on*, available at: [http://siteresources.worldbank.org/EXTINSPECTIONPANEL/Resources/InspPanel\\_Front\\_matter.pdf](http://siteresources.worldbank.org/EXTINSPECTIONPANEL/Resources/InspPanel_Front_matter.pdf).

<sup>101</sup> See generally *Daniel Bradlow*, *Differing Conceptions of Development and the Content of International Development Law*, *South African Journal of Human Rights* 21 (2005), 535.

their mission creep is an important omission that has had adverse consequences for some of their Member States and global economic governance. It also raises important questions about the role of the IFIs in the protection and promotion of international human rights and environmental law for the future.

Finally, it is our hope that this paper has demonstrated that the question of the IFIs and their compliance with international law both during their debt-related operations and more generally is a topic that merits further investigation. This is particularly the case, given that these organizations are facing complex and diverse economic, financial, political, social and environmental issues, that include the rising importance of competing official and private sources of finance for developing countries, climate change, dealing with failed States and post-conflict States, the current efforts to adjust the governance structures of the IMF and World Bank to reflect the evolving shifts in global political and economic power, and, at the time of writing, the incipient efforts to reform the institutions and arrangements for global economic governance.<sup>102</sup> Many of these issues will raise interesting international legal problems for the IFIs.

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<sup>102</sup> See, for example, *Robert Zoellick*, Modernizing Multilateralism and Markets – RBZ Speech, 6 October 2008, The Peterson Institute for International Economics, Washington D.C. and *Daniel Dombey*, U.S. to Host Summit on Economic Crisis, available at: <http://www.ft.com/cms/s/0/2b1a9e52-a04a-11dd-80a0-000077b07658.html>.