CAFTA's Debt Trap

By Aldo Caliari | June 3, 2005

Criticism of the Central American Free Trade Agreement (CAFTA) currently being considered by the U.S. Congress has focused heavily on concerns that the treaty would devastate Central American farmers who would be forced to compete with heavily subsidized U.S. agribusiness.[1] In addition, many Central Americans fear that the deal would perpetuate a low-road approach to development based on low wages and lax environmental enforcement and undermine government authority to ensure basic services and access to medicines. These are all valid concerns, but there is yet another danger posed by CAFTA that deserves greater attention.

Buried in the technical language of the investment chapter of the agreement are rules that would make it more difficult for the six nations that have signed the trade deal with the United States to escape heavy debt burdens or to prevent or recover from debt crises. The investment provisions of CAFTA, like other deals such as the 1994 North American Free Trade Agreement, are based on the argument that strong protections for private foreign investors will help encourage investments needed for economic growth. To this end, they require governments to comply with a long list of investor protections and grant private foreign investors the right to sue governments for damages if these obligations are violated.

For example, governments are required to treat foreign investors at least as favorably as domestic ones. This principle is known as "national treatment." They must also ensure what is called "most favored nation" treatment, meaning that they cannot discriminate against (or give special preferences to) the investors of one country that is a party to the agreement without granting the same treatment to investors of other parties to the agreement. These rules mean that governments cannot favor domestic interests (or investors from a particular country) even if doing so would support social goals or other national interests.

The NAFTA investor protections cover a sweeping array of types of ownership interests, including loans and securities.[2] But the CAFTA rules go even further by extending the application of such protections to sovereign debt. Under NAFTA, sovereign debt is explicitly excluded.[3] It is worth noting that the explicit exclusion comes after the use of the words "for greater certainty" which could be construed as meaning that the explicit exclusion was not necessary in the light of the other wording.

This is not the first time that a trade deal has covered sovereign debt. In the 2003 U.S.-Chile Agreement, specific principles on investment are explicitly made applicable to sovereign debt. The U.S.-Chile FTA contains a broad definition of investment[4] that follows the standard adopted by the U.S. in its most recent BIT Model.[5] This definition generally includes "bonds, debentures, loans and other debt instruments"[6] In what represents a significant departure from NAFTA, the treaty explicitly makes the provisions applicable to sovereign debts issued by the Chilean government.[7] These same rules are included in CAFTA.[8]

The rest of this article explains how the extension of CAFTA investment rules to sovereign debt places huge constraints on the ability of indebted countries to exit from a debt crisis or to protect the basic needs of its citizens.

National Treatment and MFN in the Context of Sovereign Debt Problems

The principles of Most Favored Nation and National Treatment were originally born in agreements dealing with trade in goods. The extension of these principles to investment is, therefore, neither a straightforward proposition, nor one exempt of controversy.[9] The impacts of the insertion of these principles in investment treaties have also been widely analyzed and criticized.[10] The application of these principles to sovereign debt is, in general, susceptible to the same critiques that have been made of their application to other forms of investment.

However, the extension of National Treatment and MFN principles to sovereign debt raises a number of specific issues that could prove far more harmful than the traditional application of those principles to investment in the past. Some of these issues are listed below:

1. Dismantling tools needed for the recovery of the local economy in post-crisis situations

The application of the National Treatment principle would restrict the ability of the debtor government to use tools needed for the recovery of the local economy in post-crisis situations. Applying the principle of National Treatment to sovereign debt essentially means that foreign creditors should be offered no less favorable treatment than that offered to domestic creditors.

This is important in the context of the developing country signatories of CAFTA, since, with the exception of Honduras, an important share of public debt in all these countries is owed to domestic creditors. In some of them, like Costa Rica, domestic debt is actually higher than external debt.

There are a variety of reasons why a country having to restructure its sovereign debt in order to prevent or exit a financial crisis might need to resort to offering preferential conditions to domestic creditors.

In a financial crisis, domestic creditors often suffer a "double adjustment." First, they are typically forced to accept a "haircut" on their claims, meaning that the value of their loans is reduced by a certain percentage. Second, they often suffer the costs related to the internal adjustment, such as high interest rates.[11] In fact, the impact of the restructuring on the domestic capital markets and, in turn, on the resumption of growth and repayment capacity, are important factors to take into account.[12] Along similar lines, the IMF has said that "the restructuring of certain types of domestic debt may have major implications for economic performance, as a result of its impact on the financial system and the operation of domestic capital markets."[13]

Third, dealing with domestic debt before dealing with the foreign might also allow the sovereign nation to rapidly return to domestic capital markets during what is likely to be a sustained interruption in access to international capital markets.[14]

Fourth, the debtor might also need to accord priority to domestic debt in order to protect the financial system. In this sense, it has been pointed out that sovereign debt restructuring has a double impact on the financial system. On the one hand, the impact on assets of the reduction in the value of bonds held as part of their capital by financial entities. On the other, the general increase in uncertainty, which could affect the overall credibility of the system.[15] The IMF has also stated that in these cases special treatment to domestic debt might enable the debtor to protect "a core of the banking system by ensuring the availability of assets required for banks to manage capital, liquidity and exposure to market risks."[16]

Last, a sovereign debtor might need to accord special treatment to domestic debtors for the same legitimate reasons that can lead it to accord special treatment to national sectors and industries, within the context of a national development strategy and in order to achieve development goals.[17]

2. Preventing the State from paying salaries and pensions in a debt crisis situation

The application of National Treatment to sovereign debt means that, under CAFTA, the government will be unable to prioritize domestic debt consisting of, among other things, wages, salaries, and pensions. In other words, the government is bound to treat these debts the same way it deals with foreign debts held by transnational banks and institutional investors. If its resources are enough just to cover a portion of its debts, the state will not be able to choose to direct those funds to pay wages and salaries (at least not as long as it does not devote equal amount to pay foreign creditors). CAFTA would deal a setback to states' capacity to prioritize their obligations to basic human rights and comprehensive development above the claims of foreign creditors.

Unlike an indebted private company, an indebted sovereign nation has human rights obligations and social responsibilities toward its people. This means that, in dealing with sovereign debt there are issues that cannot be addressed by strict analogies with bankruptcy principles applicable to the private sector. That is why civil society proposals for a rules-based framework have typically called for analogies to be made rather with frameworks that contemplate this special mission that the state is called to fulfill, such as Chapter 9 of U.S. Bankruptcy Law (applicable to municipalities). Whether civil society proposals call for the restructuring to preserve the ability of the state to finance the achievement of the MDGs, human rights, human needs, etc., a common element is the call to give priority to this ethical mission embodied by the state. In fact, even the IMF's much-criticized Sovereign Debt Restructuring Mechanism proposal excluded "Wages, salaries and pensions" from its application.[18]

3. Reducing the leverage of debtors in a debt restructuring

By first gathering a number of supportive domestic creditors, a government's debt restructuring offer can gain considerable clout. The offer of preferential conditions to these domestic creditors might be critical in order for the state to garner support from these creditors. This is especially so because some governments may find that it is easier or more advantageous to the economy that such incentives be offered to local holders of debt rather than foreign ones. If the principles of national treatment are applied to sovereign debt, as mandated by CAFTA, any incentive offered to domestic creditors would have to be offered to the foreign creditors, effectively foreclosing this avenue for the indebted country.

The offer of preferential conditions to domestic creditors was, in fact, a crucial element in enhancing the government's leverage in Argentina's negotiation with its private creditors after its December 2001 default (the largest sovereign default in history). In September 2003, the government released its initial proposed debt restructuring conditions, which included a 75% cut for bondholders. The government contended that this was the size of the reduction that would enable it to recover sustainable growth while ensuring that the promises of payment were kept. Some groups of bondholders quickly rejected this offer, claiming that it was woefully insufficient and, in the light of the country's latest growth figures, below the capacity of the country to repay. The creditors also strongly lobbied the G7, which, directly and through the IMF, put more pressure on Argentina to improve its offer.[19] With pressure mounting from the G7 and the IMF, Argentina turned to domestic pension funds that represented an improvement over the offer made to the other bondholders.[20] By granting them preferential conditions, Argentina was able to reach agreement with creditors holding more than 17% of its total debt. This was a critical first step in garnering the support of a majority that, eventually, totaled 76% of the creditors.

Obviously, the space for the government to treat domestic bondholders differently from foreign ones was crucial to reaching this agreement. Such resort would have been out of reach if the government had been bound by a National Treatment of foreign debt principle.[21]

4. Creation of a privilege for the debt owned (or acquired) by creditors from the Party

CAFTA is technically a collection of bilateral treaties between the United States and each of the six developing nations. Thus, by requiring national treatment and MFN only for creditors from the country that is a party to the treaty, the agreement, in fact, grants seniority to the foreign investors from that country over investors from other countries.[22]

In addition, the treaty would affect the rights of bondholders from non-Parties to the treaty without their consent since they are, by definition, excluded from intervening in the negotiation of the bilateral agreement. For these bondholders, the bilateral can be de facto equated to an involuntary debt swap by which they might suddenly find themselves holding a downgraded instrument.

Investor-State Lawsuits and Sovereign Debt

Under CAFTA, governments that violate these investor protections can face expensive lawsuits. As under NAFTA and numerous bilateral investment treaties, CAFTA grants private foreign investors the right to bypass domestic courts and sue governments in international tribunals.[23]

Such "investor-state lawsuits" are highly controversial for a number of reasons.[24] Many arbitration tribunals operate with an absolute lack of transparency, having no obligation to disclose relevant documents or allow any form of public participation.[25] The system for choosing arbitrators has also drawn criticism, as arbitrators can be drawn from the ranks of practicing investment lawyers, without any obligation to appoint people who will be independent in the sense of not having any stake in the treaty interpretation.[26]

Neither do arbitral tribunals have to pay regard to legal precedents.[27] This feature, which creates a lot of uncertainty in the investment arena, can become particularly troublesome when applied to potential or actual sovereign debt crises. Indeed, the main rationale for a sovereign debt bankruptcy system has been the need to provide some degree of rationality and predictability for both debtors and creditors in the messy process of exiting or sorting through a sovereign debt crisis. Clearly, an arbitration tribunal would do a poor job of addressing those concerns and would become an added element of uncertainty into the existing system.

The application of the principles of national treatment and MFN to sovereign debt will open new frontiers that might give these tribunals the authority to define difficult questions that arguably belong under the domestic jurisdiction of states.

Recommendations

CAFTA's application of controversial investor protections to sovereign debt would suppress the few options available to countries trying to prevent or exit from debt crises. As shown by the experience of countries undergoing such crises, inability to exit a crisis situation might cause economic losses that far outweigh any commercial gains achieved through signing a treaty. Debt campaigners are urged to join forces with trade campaigners to raise public attention to this issue and ensure it remains front and center in the debate.

Central American activists must call on their governments to reject CAFTA. In the U.S., activists must urge Congress to also reject CAFTA on the basis that congressional support for CAFTA means condemning Central American countries to a perpetual incapacity to escape their debt problems. Members of Congress who boast of supporting the reduction of external debts for Central American countries must be reminded that most of these countries also have large stocks of private debt. CAFTA will tightly tie the hands of these countries to deal with such debt.

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ENDNOTES

1 CAFTA is a bilateral treaty signed by the United States and the Central American countries of Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, as well as the Dominican Republic. CAFTA follows closely the model of other Free Trade Agreements recently signed by the U.S., which are comprehensive in scope. From the U.S. government's perspective, CAFTA represents a relatively small percentage of trade. However, just as the plethora of bilateral and regional agreements that the U.S. has recently signed or is currently negotiating, the value of CAFTA is not as much economic as political. It is meant to pave the way for completion of the Andean FTA and the FTAA, and add momentum around trade negotiations at the WTO.

2 See NAFTA Art. 1139.

3 In conformity with Art. 1416:
"investment means 'investment' as defined in Article 1139 (Investment Definitions), except that, with respect to 'loans' and 'debt securities' referred to in that Article:
(a) a loan to or debt security issued by a financial institution is an investment only where it is treated as regulatory capital by the Party in whose territory the financial institution is located; and
(b) a loan granted by or debt security owned by a financial institution, other than a loan to or debt security of a financial institution referred to in subparagraph (a), is not an investment;"
It then adds that, "for greater certainty: (c) **a loan to, or debt security issued by, a Party or a state enterprise thereof is not an investment**" (bold is ours).

4 This definition has become the standard blueprint for the U.S. negotiating position in treaties. "Investment means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:
(a) an enterprise;
(b) shares, stock, and other forms of equity participation in an enterprise;
(c) bonds, debentures, loans, and other debt instruments;
(d) futures, options, and other derivatives;
(e) rights under contract, including turnkey, construction, management, production, concession, or revenue-sharing contracts;
(f) intellectual property rights;
(g) rights conferred pursuant to domestic law, such as concessions, licenses, authorizations, and permits;11 and
(h) other tangible or intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens, and pledges; but investment does not mean an order or judgment entered in a judicial or administrative action…"

5 See U.S. 2004 Model BIT, Art. 1.

6 Usually with a footnote that clarifies "Some forms of debt, such as bonds, debentures, and long-term notes, are more likely to have the characteristics of an investment, while other forms of debt, such as claims to payment that are immediately due and result from the sale of goods or services, are les likely to have such characteristics."

7 See Annex 10-B (Annex to the chapter of the treaty that deals with investment): "The rescheduling of the debts of Chile, or of its appropriate institutions owned or controlled through ownership interests by Chile, owed to the United States and the rescheduling of its debts owed to creditors in general are not subject to any provision of Section A other than Articles 10.2 and 10.3" Articles 10.2 and 10.3 in the Treaty refer to National Treatment and Most Favored Nation.

8 See also Ugarteche 2004, 14-18 and 34-35.

9 See Khor 2002 ("It is certainly not clear that the principles of the WTO (including National Treatment and Most-Favoured-Nation treatment) that apply to trade in goods should apply to investment, nor that, if applied, they would benefit developing countries.")

10 See for instance Chang (2003), Action Aid (2003), Oxfam (2003).

11 Machinea 2004, 188.

12 Id.

[13] IMF 2002, 13.

[14] Id.

[15] Machinea 2004, 188-9.

[16] IMF 2002, 13.

[17] See also IMF 2002 13 agreeing, while on different grounds, with the possible need for the government to shelter domestic investors from the full impact of the restructuring. The IMF argues this might be necessary in order to "garner support for an ambitious adjustment program."

[18] IMF 2003, 24.

[19] As per its IMF agreement, the Argentine government had promised to "negotiate in good faith;" Argentina was singled out by name in some G7 statements as not complying with such pledge. Private creditors have said negotiations in good faith mean an agreement of 80% of the creditors, while the government claimed that something above 65 or 70% would do. It would have, of course, sounded weird and unfair that the IMF or the G7, being some of the creditors, be able to unilaterally define what a condition subscribed by Argentina meant in terms of an exact percentage. However, that is perfectly possible in real political economy terms.

[20] The offer consisted of inflation-linked bonds.

[21] This without mentioning that improving the offer to the pension funds will translate into improvements in the retirement benefits of a population hit by the crisis where the privatization of the pension system left people without other option than pension funds.

[22] It is unclear and will be the matter of interpretation whether the definition of foreign debt has to do with debt belonging to the creditor originally or by acquisition. In the case of bonds, where the holder is entitled to the payment, this distinction might be irrelevant; in the context of debt from other sources the distinction might be applicable.

[23] Peterson 2004, 3.

[24] For a survey of issues arising from Treaty-based arbitration disputes see Peterson 2004 and 2004a.

[25] Peterson 2004, 4.

[26] Peterson 2004a, 12.

[27] Peterson 2004, 6.

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