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Coopération Internationale pour le
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Caritas
Internationalis

SUSTAINABILITY AND JUSTICE

A Comprehensive Debt Workout for Poor Countries with An International Fair and Transparent Arbitration Process (FTAP)

A CIDSE-Caritas Internationalis
Position Paper

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NB: the first draft of this position paper was written by Martina Neuwirth (KOO) and includes contributions from members of the CIDSE/CI Task Group on Debt and Structural Adjustment (TG3). The part on Catholic Social Teaching was written by Seamus O'Gorman (International Jesuit Network on Debt). The revised version was edited by Georg Stoll (Misereor) in cooperation with Aldo Caliari (Center of Concern) and Ann De Jonghe (Broederlijk Delen).

Sustainability and Justice: A Comprehensive Debt Workout for Poor Countries With an International Fair and Transparent Arbitration Process (FTAP)

INTRODUCTION

The last two decades have seen the economic prospects of many developing countries thwarted by debt crises. Creditors have responded with a series of piecemeal but ultimately unsatisfactory mechanisms. The last example is the Highly Indebted Poor Countries (HIPC) II initiative outcomes of which are to be evaluated in 2004, when the initiative according to its prescheduled "sunset clause" expires. Notwithstanding some positive results especially in some areas of social spending it becomes clear that HIPC-II will not provide the definite exit solution for heavily indebted poor countries it was meant to be. Some countries such as Zambia are paying more debt service after HIPC-II than they did before. Others such as Bolivia are already falling back to unsustainable debt levels. And Ethiopia the last graduate of the initiative – though benefiting from topping-up relief at completion point – is expected to reach sustainability in the terms of the World Bank and International Monetary Fund (IMF) not before 2020. The growing frequency and persistence of developing country over-indebtedness is symptomatic of a deeper problem of political imbalance, in which creditors have control over the timing, pace and depth as well as economic and political conditionality of debt relief mechanisms.

The same basic situation is observable in indebted Middle Income Countries (MIC). Many of them have unsustainable long-term debt stocks, Argentina being only the most famous recent case. But while the IMF tried to address the problem of the deficiency in creditor coordination (especially between public and private creditors) with its SDRM initiative (Sovereign Debt Restructuring Mechanism) the central point of the present non-comprehensive procedures was missed: the non-participation of those who are most strongly affected by debt crises – the population of indebted countries, especially the poor.

This situation of systemic power imbalance fuels the vicious circle of over-indebtedness, poverty and economic underdevelopment thus perpetuating the critical living conditions of hundreds of millions of people. It also undermines the sovereignty of poor countries and their populations and violates their dignity and their right to self-determination. CIDSE and Caritas Internationalis therefore consider this imbalance as a serious obstacle to a sustainable solution to the ongoing debt crisis of poor countries and to more justice at the global level. Moreover, we emphasise that as signatories of the International Covenant on Economic, Social and Cultural Rights, most debtor and creditor countries are committed to ensuring the basic rights to food, education, health and other basic economic and social rights. Unsustainable external debt is one of the major causes of the continuous violation of these rights, therefore making it the responsibility of debtors and creditors to agree to a procedure of resolving the debt problem that takes into account their responsibilities and the unalienable rights of all human beings.

As Christian organisations committed to international solidarity and human liberation, we call for the cancellation of unsustainable debt that prevent individuals and communities from realising their full human potential and specifically, those who suffer most in the present situation: the poor. We share the concern of many of our partners in the South that only a fundamental change in the international management of external debt and over-indebtedness can lead to a sustainable and just solution for this. We, therefore, strongly support the idea and the implementation of a Fair and Transparent Arbitration Process (FTAP) where creditors and debtors alike (including civil society) guided by a neutral arbitration body negotiate and decide the conditions for a sustainable exit from over-indebtedness.[1]

This paper begins with a small introduction on the catholic ethical views on debt underlying our demand for an FTAP (chapter I). It then highlights the background (chapter II) and recent political developments (chapter III) in the debate for a more transparent and power balanced debt-workout mechanism. The paper concludes with the CIDSE/CI position on the FTAP proposal (chapter IV).

[1] While advocating for the FTAP proposal, we believe that proposals for an International Arbitration Court for Debt, as proposed by Afrodad, or the TIADS proposal (Tribunal Internacional de Deuda Soberana), as proposed by Latin American economists, share the same basic principles and features and all three need equal consideration in the discussion on external debt management and over-indebtedness (see references at the end).

I. CATHOLIC VIEWS ON THE ETHICS OF DEBT

CIDSE is a network that brings together 15 Catholic development organizations from Europe and North America. Caritas Internationalis is a network of 162 Catholic relief, development and social service organisations present in 201 states and territories throughout the world. As Catholic networks we are inspired by the daily struggles of women and men around the world working for a humanising transformation of the global economy. We are also guided by a long history of reflection and debate in Catholic Social Teaching (CST) about the choices we can make so that political and economic affairs are shaped in ways which will serve the needs of all peoples. We are particularly concerned with the worldwide challenges of the creation and distribution of wealth in a way which can achieve the urgent eradication of currently intolerable levels of poverty.

Ethical Principles

More than forty years ago Pope John XXIII in his major encyclical *Pacem in terris* stressed some insights that contain valuable ethical guidance to the present day.

1. Political and international affairs and the multiplicity of arrangements which constitute the international economic, social and political order need to be ruled by moral values recognisable by all people.[2]

2. The increasing recognition of human rights, grounded in the dignity of all human beings offers great hope for a better solution to world crises.

3. There is an urgent need to strive for the creation of international forms of government to ensure the ability of a globalising world to truly work for the common good.

In developing our position with regard to a Fair and Transparent Arbitration Process (FTAP) we lean on these insights and their subsequent development. In considering proposals which will affect financial opportunities for millions, we start from the core belief affirmed repeatedly by John Paul II, that the goods of the earth are given by God to 'the whole human race for the sustenance of all its members, without excluding or favouring anyone' (*Centesimus annus 31*, 1991). Catholic Social Teaching does acknowledge the *potential* positive role of the market in the international economy. However, we are equally aware that leaving the development prospects of nations, and millions of people at the mercy of international financial markets is to abnegate our moral and ethical responsibilities, as nations, as governments, and as public officials.

Power and Responsibility in Free Markets

Catholic Social teaching has always pointed out that world markets, including labour, trade and financial ones, are dominated by the realities of power. Agreements presented as free contracts, and so as bearing the full consequent obligations between employee and employer, or trading nations, or borrower and lender are in reality shaped by unequal power relations.[3] Whatever claims are made in favour of the markets we recall the fact that 'there are many human needs which find no place on the market'. With John Paul II we insist that it is 'a strict duty of justice not to allow fundamental human needs to remain unsatisfied, and not to allow those burdened by such needs to perish' (*Centesimus annus* 34). In the face of the inequality on which international financial markets are founded Catholic teaching does not passively or fatalistically accept this as the way of the world, but calls on those with power, and especially those with government power to pro-

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[2] 'With respect to States themselves, Our predecessors have constantly taught, and We wish to lend the weight of Our own authority to their teaching, that nations are the subjects of reciprocal rights and duties. Their relationships, therefore, must likewise be harmonized in accordance with the dictates of truth, justice, willing cooperation, and freedom. The same law of nature that governs the life and conduct of individuals must also regulate the relations of political communities with one another.' (Encyclic *Pacem in Terris, Nr. 80*, 1963)

[3] For example Paul VI writes: 'When two parties are in very unequal positions, their mutual consent does not guarantee a fair contract. The rule of free consent remains subservient to the demands of natural law.' (Encyclic *Populorum progressio, Nr. 59*, 1967)

tect the weaker parties to such contracts.[4] As we become more and more conscious of the extent and the limits of globalisation we stress 'that it is the universal common good which demands that control mechanisms should accompany the inherent logic of the market' (John Paul II, Address to Pontifical Academy of Social Sciences, 2001). Ensuring that there are such control mechanisms which serve the common good is the responsibility of governments.

Debt Crises: Guiding Questions

The Catholic Church has been carefully following the debates around international debt over a long period. While recognising the principle that debts should be paid, CST places very clear limits on the extent of this obligation. For us, in the face of the continued unwillingness of political leaders to provide a human solution to the blight caused by international debt, the words of John Paul II remain as important as ever. 'It cannot be expected that the debts which have been contracted should be paid at the price of unbearable sacrifices' [*Centesimus annus* 35]. We also believe that there can be no human development which does not allow people to be active participants in the key decisions which determine its possibilities. Not to allow for meaningful participation is to deny the basic human dignity of people and poorer nations.

Catholic Social Teaching does not prescribe detailed answers on specific proposals with regard to economic development. But faced with proposals being made to shape the international community's response to debt problems it does urge us to ask the following basic questions:

1. Does the proposal move us in the direction of achieving progress in ensuring that the goods of the earth are distributed in a way which respects the basic human rights of all people?

2. Does the proposal allow for effective international government co-operative action to protect the needs of the poor?

3. Does the proposal allow for meaningful participation of those who will be most affected by its measures?

These questions are in accordance with two principles of the Church's Social Teaching:

1. The principle of *subsidiarity* – where the decisions that most affect poverty reduction efforts of peoples and whole communities must be most influenced by those peoples and communities;

2. The principle of the *preferential option for the poor* – where the economic decisions that affect whole countries must start with a full consideration of their effects on poor people.

II. BACKGROUND

Since the outbreak of the debt crisis in the early 1980s, various solutions were proposed by commercial creditors (with the so-called Brady initiative) and by sovereign creditors (with various Paris Club arrangements) and, more recently with the Heavily Indebted Poor Country (HIPC) Initiative of the World Bank and IMF. The HIPC framework marked the first real attempt to establish a more comprehensive approach to low-income debtor countries.

Most of these initiatives have proved inadequate. Even the more comprehensive HIPC Initiative failed to meet either of its key objectives – a robust exit from unsustainable debt and a clear integration of poverty reduction goals.

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[4] 'Considerations of justice and equity can at times demand that those in power pay more attention to the weaker members of society, since these are at a disadvantage when it comes to defending their own rights and asserting their legitimate interests.' (*Pacem in terris, loc.cit., Nr. 56*)

The 1990s also witnessed the growing severity and frequency of debt crises for middle-income countries. These new and more rapid crises have largely arisen from the integration of the capital markets in emerging market economies and the introduction of IMF-recommended capital account liberalisations. The resulting huge inflows of volatile capital – leading to crises in Mexico, Asia, Russia and Argentina – have made it necessary for the IMF to organise increasingly expensive rescue packages. But even these "rescues" have led to criticism of the IMF for bailing out private lenders with public money at the expense of the longer-term development prospects of millions of people. In other cases such as former Yugoslavia or, more recently Iraq, the readiness of bilateral and multilateral creditors to grant substantial debt relief is guided by strong political (and economic) interests – adding to the lack of transparency and inequality of the present international debt management procedures.

While the debt crises in middle-income countries have led to increasing costs, debt-restructuring packages have become more complicated. There is now a greater diversity of creditors (including banks, bond holders, trade financiers) involved in restructuring exercises. Debt restructuring packages that require collective action and coordination between creditors and debtors have become even more difficult to reach. According to the IMF, "the present process for restructuring … is more prolonged, more unpredictable and more damaging to the country and its creditors than would be desirable." Moreover, the absence of a "predictable and equitable process … makes it more difficult to attract long-term capital to the emerging market asset class …" (Anne Krueger, April 2002, p.20).

Mounting public sector costs and the complexities associated with private sector bailouts have added to the pressure for a more comprehensive approach and for burden sharing between creditors, particularly the "bailing-in" of private sector creditors. This has resulted in the IMF putting forward its proposals for a new debt restructuring mechanism in which some of the principles of domestic insolvency procedures are applied to sovereign countries.

The call for such a mechanism originally came from another side. Non-Governmental and church-related Organisations within the framework of the global "Jubilee Campaign" in the 1990s and some scientists such as the Austrian economist Kunibert Raffer had already argued in favour of a neutral debt workout process which draws from the experience of insolvency procedures. They found support in Chapter 9 of the US Civil Code which regulates insolvency cases of municipalities taking into account their special situation as public bodies with responsibilities and duties towards their citizens.

But this demand for an "international insolvency law" which later became known as the "Fair and Transparent Arbitration Process" (FTAP) did not reach the ears of creditors and International Financial Institutions for years. It was only in the context of the above-mentioned Argentinean debt crisis in 2000-2001, and the emerging consensus in the Financing for Development Conference around the need for an international debt workout mechanism, that the International Monetary Fund (IMF) made an unexpected turn in November 2001 by putting forward its proposal for a new "Sovereign Debt Restructuring Mechanism" (SDRM). CIDSE and Caritas Internationalis welcomed the initiative to debate SDRM proposals as a first step towards establishing a fairer resolution of debt crises. The SDRM proposal implicitly admits the deficit of an incomprehensive piecemeal approach such as that presently in use. It rightly acknowledges that a new, predictable debt resolution mechanism could reduce restructuring costs for debtors and creditors alike and would speed up the resolution of a country's indebtedness.

However, the SDRM has some substantial flaws as well. It involves a cumbersome decision-making procedure that retains most of the inequities of existing processes. Primarily addressing public debt owed to private sector creditors the SDRM fails to deal with multilateral debt and bilateral creditors. More important the SDRM, as the IMF has designed it, does not comply with basic demands regarding impartiality, transparency and a poverty perspective.

The exempt status of the IMF would be reinforced in the framework of an SDRM by giving the IMF management a prominent role in choosing the members of the "Debt Resolution Forum" the institution heading an SDRM. The IMF's power would be further strengthened by subjugating debtors to additional IMF conditionalities and by the IMF continuing to define debt sustainability (despite the fact that this role for the IMF has been frequently criticised, not only on the grounds of its lack of expertise, but also on the grounds of conflict of interest arising from its performance of both analytical and lending functions.

III. POLITICAL DEVELOPMENTS

The SDRM proposal was discussed for several months at various international meetings. During these discussions, CIDSE and Caritas Internationalis demanded that the role of the IMF be restricted to that of a lender. The IMF might act as a consultant on behalf of all or some creditors, if they wished to do so. But it should not act in any "independent" role because of its creditor function.

Caritas Internationalis and CIDSE also mentioned that the proposed SDRM mechanism was neither transparent nor poverty focused. Poverty reduction was not considered as a criterion for the amount of debt reduction a country would receive, nor would the SDRM take steps to ensure that poor people benefit from any negotiated solution. The IMF proposal did not touch important issues such as the participation of stakeholders beyond private creditors (particularly the debtor country's population), transparency or the analytical framework used to judge debt sustainability. Despite some rhetoric the SDRM did not pay any heed to ensuring the consistency of debt sustainability thresholds with internationally agreed poverty reduction objectives, such as the Millennium Development Goals.[5]

CIDSE and Caritas Internationalis raised these concerns in public and also addressed them to the IMF. Among other activities, the Annual Meeting in September 2002 offered an opportunity to organise a panel discussion on the issue (together with Washington-based Center of Concern and New Rules). In January of the same year, CIDSE/CI took part in an IMF-hosted conference on SDRM in Washington and contributed an earlier version of the present paper as a NGO background position. One year later, in January 2003 we presented and discussed the FTAP proposal at the World Social Forum in Porto Alegre. In March 2003 we organized a panel on Debt/SDRM at the UN-ECOSOC interactive dialogue with NGOs in New York.[6] Together with 35 Bishops from 20 countries in the North and South CIDSE/CI wrote a letter to the Managing Director of the IMF in the run-up to the Spring Meeting of the International Financial Institutions in 2003. In this letter we called for the integration of a genuine poverty perspective into the SDRM negotiations and recalled the necessity of authentic civil society participation and of an orientation towards true justice between debtors and creditors if the SDRM were to meet basic ethical preconditions of an international framework.

The SDRM initiative of the IMF was blocked at the Spring Meeting of the IMF and World Bank in 2003. Opposition mainly came from the US Treasury Department which did not want to see a legally binding framework, preferring the voluntary inclusion of so called 'Collective Action Clauses' (CAC) in bond contracts instead. Emerging market countries were reluctant too. Their main concern was that their borrowing conditions would be negatively affected by the simple existence of a debt workout mechanism that would bail-in private creditors stronger than before.[7]

Caritas Internationalis and CIDSE do not believe that the official proposals for a Sovereign Debt Restructuring Mechanism are sufficient to address the systemic debt crises. Neither do we believe that these proposals adequately fulfil the mandate emanating from the Monterrey Consensus, wherein Para 60 calls for "…consideration by all relevant stakeholders of an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely

[5] The Millennium Development Goals (MDG) are listed in the Millennium Declaration which was endorsed by all 189 member states of the United Nations at the end of the Millennium Summit in September 2000. The eight MDGs aim at combating hunger and poverty and improving education, health, the status of women and the environment by the year 2015. These goals constitute an international commitment by all governments, agreed by their heads of state.

[6] For documentation see http://www.un.org/esa/ffd/cs_ecosoc_spring_2003.htm. CIDSE/CI documents referring to the other above mentioned events can be found in the references list at the end.

[7] It is worth mentioning that there is no clear evidence that a comprehensive debt workout by arbitration would worsen the borrowing conditions of a debtor country. Rather, the historical experience of Germany after 1953 and of Indonesia after 1969 would point in the opposite direction - though these cases do not encompass all the elements of an FTAP. Also, the recent use of CAC by Uruguay, Mexico and Brazil in the summer of 2003 show that provisions to bail in private creditors in possible defaults do not necessarily increase the costs of the loan. An analysis of the credit costs of those countries that underwent debt restructuring according to the Brady plan in the early 1990s leads to the same conclusion: that there is no empirical proof for the assumption that debt relief automatically increases credit costs. The rationale behind these findings follows the logic of economics: a heavily indebted country that is willing to pay but lacks resources is a "better" debtor after debt relief than it was before.

and efficient manner…”[8] We therefore opt for a Fair and Transparent Arbitration Process. The voluntary inclusion of CAC may be a small step forward to creditor coordination in new bond contracts. However, they do not offer an exit to any of the already existing contracts. Nor do they allow for civil society in debtor countries to be heard. The concerns of emerging market countries on the other hand clearly reflect the coercive power of the international financial markets which act without any regard to the living conditions of those who are the most vulnerable to their effects: the poor in heavily indebted countries.

While the status quo gives centrality to the interest of creditors (including multilateral institutions), we believe that resolving debt crises can only work when the basic human needs and rights of the poor are met. A mechanism which ends up adopting a one-sided emphasis, that is, on the rights of creditors – private and public – while ignoring the most vulnerable, cannot meet these demands. Therefore we still see an urgent need for a systemic change of international debt management in the direction of a FTAP. Voluntary Codes of Conduct which are discussed in this context cannot provide a sufficient answer to this systemic problem of a one-sided bias – as they keep all control on procedures and results in the creditors' hands.

CIDSE/CARITAS INTERNATIONALIS PROPOSAL FOR A FAIR AND TRANSPARENT ARBITRATION PROCEDURE[9]

A Fair and Transparent Arbitration Procedure would establish a comprehensive mechanism that would be open to all countries and that would address private as well as bilateral and multilateral debts. The FTAP proposal argues that a truly comprehensive debt restructuring process must be driven by an independent institution, such as an international arbitration panel. The population of the debtor country, through its representatives (parliament, chambers of commerce, trade unions, grassroots organisations, churches, NGOs, etc.) should have the right to be heard before the panel. This panel – whose members should be chosen by the debtor and the creditors alike – would determine debt sustainability thresholds consistent with basic economic and social rights and with internationally agreed poverty reduction objectives such as the Millennium Development Goals.[10] The panel would also be the forum where the legitimacy of the individual creditor claims can be questioned and scrutinized. The panel's judgement would aim to bring down debts to sustainable levels where analyses of sustainability take into account first and foremost the financing of poverty reduction programmes. Furthermore, CIDSE and Caritas Internationalis propose that creditors and the debtor country must agree on safeguards to redirect debt reduction savings to these programmes.

We understand our proposition of a debt restructuring mechanism as a modification of the proposed Fair and Transparent Arbitration Procedure promoted by many non-governmental organizations in the North and in the South.[11] The key features of the mechanism should be as follows:

- The process shall be open to ALL debtor countries, including HIPCs.
- The start of the process shall automatically trigger a standstill on all external debt repayments. This would protect countries from litigation by creditors such as "vulture funds".
- The debtor and the creditors alike shall choose the members of an independent arbitration panel that could be established in an ad hoc manner.[12] Ultimately a more permanent independent body to deal with

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[8] UN International Conference on Financing for Development (March 2002), Monterrey Consensus (A/Conf/198/3), para. 60. Also see para 51: "(…) We emphasize the importance of putting in place a set of clear principles for the management and resolution of financial crises that provide for fair burden-sharing between public and private sectors and between debtors, creditors and investors....''

[9] This section is partly based on the research of Prof. Kunibert Raffer (Univ. of Vienna) who has been working on this issue for the past 15 years, and Jürgen Kaiser (Erlassjahr.de, Germany). See Raffer, Kaiser, Fritz/Hersel under "References".

[10] The present developments in the approach towards debt sustainability thresholds as reflected in recent documents from the IMF and the World Bank (especially IMF/IDA 2004) highlight the shortcomings of threshold definitions which depend on lending agencies such as the Bank and the Fund. For a critique of this biased approach see CAFOD/Trócaire/Oxfam/ Action Aid 2004.

[11] The modification consists of a stronger emphasis on the goal of poverty reduction expressed, e.g. in the proposal to provide for reliable control systems regarding the use of debt savings.

successive debt crises could be institutionalised within a structure such as the United Nations, given its special responsibility for the follow-up to the Financing for Development process.[13]

- Debt sustainability shall be judged by this independent panel. It will ensure considerations of debt sustainability within the development context of each debtor country whereby government revenues are balanced against the needs to finance poverty reduction programmes.[14]
- Similarly, creditors and debtors would reach a specific agreement for using the debt savings in part to benefit the poorest and most vulnerable sectors of the population. The independent panel would judge the adequacy of this agreement.
- The population of the debtor country, through its representatives (parliament, chambers of commerce, trade unions, grassroots organisations, churches, NGOs, etc.) shall have a right to be heard before the panel and will assess the balance of interests between the creditors, the priority need to finance poverty reduction programmes as well as the debtor country's medium to long term economic interests.
- The role of the IMF shall be restricted to that of a lender. The IMF cannot act in any "independent" role because of its creditor function.
- The whole process as well as the decisions of the panel shall be made public.

CONCLUSIONS

As international development and advocacy agencies that focus on the consequences of debt crises for the poorest and most vulnerable people, CIDSE and Caritas Internationalis have long advocated for an alternative debt restructuring mechanism that would be a "fair and transparent procedure for fair and equal relationships between debtors and creditors." An "international procedure" where "neutral courts of arbitration" are established is a mechanism championed by our networks as a way of providing a durable solution to this problem.[15]

The present situation (with, for example, the imminent failure – to a large extent – of the HIPC initiative) requires that we take into account the seriousness of the systemic dysfunction of international debt management, which has led to the SDRM proposal. This is acknowledged in Paragraph 60 of the Monterrey Consensus which recognises the need "to promote fair burden-sharing and minimise moral hazard" by the consideration by "all relevant stake-holders of an international debt workout mechanism…" And it also offers the opportunity to develop and promote a better alternative in the context of the Financing for Development follow-up process – the UN being more legitimate to host and coordinate these efforts than the IMF.[16]

We believe that there is an opportunity to create such a mechanism which will be in a better position to support effective poverty reduction, will express governments' commitment to protect the vulnerable, and will allow the genuine integrity of the mechanism to be checked through ensuring adequate participation of those whose lives would be most seriously affected by it.

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[12] The restructuring of the external debt of Indonesia in 1970 may provide an example for independent arbitration. Thomas Kampffmeyer who examined the case underlines the importance of debt restructuring being the result of negotiations rather than being dictated by either side. See Kampffmeyer 1987.

[13] This responsibility is contained in the Monterrey Consensus, paragraph 60: 'To promote fair burden-sharing and minimize moral hazard, we would welcome consideration by all relevant stakeholders on an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner.' UN International Conference on Financing for Development (March 2002), Monterrey Consensus (A/Conf/198/3), para. 60.

[14] CIDSE / Caritas Internationalis: Human Development Approach to Debt Sustainability Analyses (2001).

[15] CIDSE / Caritas Internationalis: Putting Life Before Debt (1998), p. 17.

[16] In this sense it is deeply regrettable that efforts to continue the work on a comprehensive, coherent and fair debt workout mechanism within the framework of the Follow-up to the International Conference on Financing for Development did not meet the necessary support at the High-Level Dialogue on Financing for Development in November 2003. It is our hope that the Multi-Stakeholder Consultations on "Sovereign Debt for Sustained Development" scheduled to take place in preparation for the next High-Level Dialogue on Financing for Development will again put the question of a FTAP on the agenda of international debate.

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Members of CIDSE-Caritas Internationalis (CI) Task Group on Debt and Structural Adjustment

BROEDERLIJK DELEN
Contact person: Ms. Ann De Jonghe
165, Huidevettersstraat
1000 BRUSSELS
BELGIUM
Tel: (32) 2 213 04 31
Fax: (32) 2 502 81 01
Email: ann.dejonghe@broederlijkdelen.be
Website: http://www.broederlijkdelen.be

CAFOD – Caritas England and Wales (CIDSE/CI)
Contact person: Mr. Henry Northover
2 Romero Close - Stockwell Road
LONDON SW9 9TY
UK
Tel: 44-20-73265670
Fax : 44-20-72749630
Email: hnorthover@cafod.org.uk
Website: http://www.cafod.org.uk

CARITAS ESPAÑOLA (CI)
Contact person: Mr. Jaime Atienza
San Bernardo, 99 bis - Apartado de Correos n. 10095
28015 MADRID
SPAIN
Tel: 34-91-4441090
Fax: 34-91-5934882
Email: jatienza.ssgg@caritas.es
Website: http://www.caritas-espa.org

CCFD (Comité Catholique contre la Faim et pour le Développement)
Contact person: Mr Jean Merckaert
4, rue Jean Lantier
75001 PARIS
FRANCE
Tel: (33) 1 44 82 80 00
Fax: (33) 1 44 82 81 43
Email: j.merckaert@ccfd.asso.fr
Website: http://www.ccfd.asso.fr/

CENTER OF CONCERN
Contact person: Mr Aldo Caliari
1225 Otis Street N.E.
WASHINGTON DC 20017
UNITED STATES
Tel: (1) 202 6352757
Fax: (1) 202 8329494
Email: aldo@coc.org
Website : http://www.coc.org

CORDAID – CARITAS NETHERLANDS (CIDSE/CI)
Contact person: Mr Johan van Rixtel
Postbus 16440
2500 BK THE HAGUE
THE NETHERLANDS
Tel: (31) 70 3136 300
Fax: (31) 70 3136 301
Email: johan.van.rixtel@cordaid.nl
Website: http://www.cordaid.nl

DEVELOPMENT & PEACE – CARITAS CANADA (CIDSE/CI)
Contact person: Ms. Mary Durran
5633 Est, rue Sherbrooke
MONTREAL - QUEBEC H1N 1A3
CANADA
Tel: (1) 514 257 87 11
Fax: (1) 514 257 84 97
Email: mary.durran@devp.org
Website: http://www.devp.org

FONDAZIONE GIUSTIZIA E SOLIDARIETA – CARITAS ITALIANA (CI)
Contact person: Mr. Riccardo Moro
Via Aurelia, 468
00165 ROMA
ITALY
Tel: 39-06-66398433
Fax: 39-06-66398434
Email: r.moro@chiesacattolica.it

KOO
Contact person: Ms. Hildegard Wipfel
Türkenstrasse 3
1090 VIENNA
AUSTRIA
Tel: 43-1-317032177
Fax: 43-1-317031285
Email: h.wipfel@koo.at
Website: http://koo.at

MISEREOR
Contact person: Mr Georg Stoll
9, Mozartstrasse - Postfach 1450
52064 AACHEN
GERMANY
Tel: (49) 241 44 20
Fax (49) 241 44 21 88
Email: stollg@misereor.de
Website: http://www.misereor.de

SECOURS CATHOLIQUE - CARITAS FRANCE (CI)
Contact person: Mr Jean-Pol Evrard
106 rue du Bac
75341 PARIS Cedex 07
FRANCE
Tel.: (33) 1 45 49 73 30
Fax: (33) 1 45 49 94 50
E-mail: jean-pol-evrard@secours-catholique.asso.fr
Website: http://www.secours-catholique.asso.fr

TRÓCAIRE – CARITAS IRELAND (CIDSE/CI)
Contact person: Ms Caoimhe de Barra
Maynooth - Co.Kildare
IRELAND
Tel: (353) 1 629 3333
Fax: (353) 1 629 0661
E-mail: cdebarra@trocaire.ie
Website: http://www.trocaire.org

CIDSE Secretariat
Contact person: Ms Jean Letitia Saldanha
Rue Stévin 16
1000 BRUSSELS
BELGIUM
Tel: (32) 2 233 37 53
Fax: (32) 2 230 70 82
Email: saldanha@cidse.org
Website: http://www.cidse.org

Caritas Internationalis Secretariat
Contact person: Mr Jacques Bertrand
Palazzo San Calisto
00120 VATICAN CITY
Tel (39) 06 698 797 99
Fax (39) 06 698 872 37
Email bertrand@caritas.va
Website : http://www.caritas.org