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JUSTICE AND DEVELOPING COUNTRY DEBT

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ABSTRACT

This paper draws on recent discussions by lawyers, theologians, philosophers and economists to reach some conclusions about the just international treatment of the government over-indebtedness and insolvencies that have occurred and recurred many times in many developing countries. It asks what should be considered "fair" expectations in the relationship of government borrowers and their lenders. It also considers some proposed reforms in the international treatment of sovereign borrowing and debt that are prompted by the ethical analyses.

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Introduction

As of December 2005, the governments of developing countries owed or guaranteed almost $1.5 trillion in foreign debt obligations, more than half of the $2.8 trillion owed abroad by public and private sectors together in developing countries.[1] This amount of foreign government debt, let alone the untold amount that governments owe in their own currencies to their own residents and institutions, is not in itself a problem. Governments, like enterprises and households, would pass up far too many opportunities for economic growth and social advancement if they did not borrow at all. It is a question of how much is borrowed and on what terms that matters. The countries that account for most of the huge amount of sovereign debt in the developing world are well able to handle their debt, just as most households in the world successfully manage their personal finances. Usually, the authorities in these countries act prudently and in an informed way, and they are also lucky.

The difficulty comes when governments, like many enterprises and households, find their debt has grown beyond what they can reasonably manage. They may or may not have acted prudently or have been well informed about the obligations they undertook, but they were also decidedly unlucky. When default becomes inescapable, the debts that governments cannot pay are almost always owed in foreign currency to foreign creditors and these are the debts on which we will focus. Like debt default for households, inability to stay current on payments on external debt cause deep economic traumas.

The recent Argentine experience illustrates the dimensions a debt crisis can take in a middle-income country. In Argentina, where life expectancy at birth is 75 years and approximately 97% of the population is literate, almost half the population was pushed below the poverty line by the trough of the crisis in 2002, the year following the debt default and collapse of its fixed exchange rate system.[2] Poverty of that magnitude, unfortunately, is the "normal" situation in the lowest income countries regardless of debt default. Indeed, almost half the population of Sub-Saharan Africa lives on incomes of less than one dollar per day (a shorthand for extreme poverty), and three quarters of the population live on less than two dollars per day.[3] Poor countries that also suffer from debt problems in this region thus face obstacles added to the "normal" ones in overcoming poverty.

Moreover, there are too many sovereign debt crises in developing countries. The International Monetary Fund (IMF) counts 56 countries that had arrears in their foreign

[1] Data of World Bank, *Global Development Finance, 2006* (Washington, D.C.), Volume I, Statistical Appendix.
[2] More precisely, 45.4% of the urban population fell below the poverty line in 2002, roughly double what it was in 1990, and 18.6% of the population of the major metropolitan areas was classified as "indigent", compared to 5.2% in 1990 (see UN Economic Commission for Latin America and the Caribbean, *Statistical Yearbook for Latin America and the Caribbean, 2005*, Santiago, Chile, July 2006; the poverty line is defined as an income level less than twice the cost of a basic food basket and "indigent" entails income less than the cost of the food basket).
[3] Data of World Bank, *Global Development Prospects, 2006* (Washington, D.C.), p. 9.

debt payments or rescheduled their debt-servicing obligations during 1999-2003. Together, these countries accounted for one fifth of world population, over 1 billion people, but less than 6 percent of world output.[4] As can be inferred, the debt crisis countries are mostly low-income ones, although middle-income countries have also had to restructure external debts that they could no longer service, including Argentina, the Dominican Republic and Iraq in 2005. These persisting facts have made sovereign debt crises in developing countries a major international policy concern. Indeed, if there is a consensus on any aspect of developing country debt, it is that new crises will erupt in the future, perhaps not next year, but perhaps during the next global economic downturn, perhaps before.

When sovereign debt crises burst open, there is considerable economic pain, but ultimately the crisis is resolved one way or another. There is a vast literature on why debt crises occur and on the processes for resolving them. There is a rapidly growing literature advising governments how to avoid debt crises — how to maintain debt "sustainability", albeit without a consensus on what the indicators of sustainability should be. There have been many proposals for reforming the sovereign debt workout process, going back at least to the debt arbitration mechanism adopted in the Hague Convention of 1907.[5] There seems to be a smaller literature on the ethical issues embodied in sovereign debt and its crises, and what a "just" workout mechanism might look like. This paper investigates those questions.[6]

After an introductory survey of the actors, their interests and *modes operandi* in sovereign debt and how debt crises are resolved in practice, we ask what a theological focus brings to the discussion of sovereign debt problems. This is followed by discussion of some philosophical questions regarding where to place responsibility for debt problems and what consequences that should have on debt crisis resolution. The extreme case of "odious" debt is also considered, especially in the context of an international sanctions regime to change odious state behavior. Finally, we claim that justice demands that sovereign debt crises be treated in some yet-to-be-designed official international forum.

The Players and the Game of Sovereign Debt

Before entering directly into the ethical issues in debt, it seems useful to briefly recall who the parties are in a sovereign debt crisis.[7] This begins, of course, with the

[4] Data of IMF, *World Economic Outlook, September 2006* (Washington, D.C.), pp. 182 and 186n

[5] See "Laws of War: Limitation of Employment of Force for Recovery of Contract Debts (Hague, II), October 18, 1907 (http://www.yale.edu/lawweb/avalon/lawofwar/hague072.htm).

[6] This paper is an outgrowth of a project the author co-directed with Christian Barry of the Carnegie Council for Ethics in International Affairs. Several papers prepared for that project are being published in the journal *Ethics and International Affairs*, vol. 21 (Nos. 1 and 2), Spring 2007. These and other papers for the project will be collected in a volume edited by Christian Barry, Barry Herman and Lydia Tomitova to be published by Blackwell Publishing, Boston, Massachusetts, forthcoming in 2007.

[7] For an elaboration of these notes, see Barry Herman, "Introduction: The Players and the Game of Sovereign Debt," *Ethics and International Affairs*, op. cit., pp. 5-32.

developing country government as borrower. Most governments have a diverse set of creditors, including commercial bankers, purchasers of government bonds, other governments that lend to them and the international financial institutions (IFIs), principally the IMF and the World Bank. When a debt default throws the debtor and its creditors together — and the usual event is a broad default, although almost always excluding a cessation of payments to the IFIs — the various creditors bring different views on the need for speed, let alone on the sharing of losses, in a negotiated workout from the default.

Repayment amounts and terms that are applied to the different types of creditors result from separate negotiations in different institutions or forums. Debts owed to governments are restructured by decision of the main "bilateral" creditors meeting in the Paris Club; debts owed to commercial banks are renegotiated with ad hoc banker groups called London clubs (or Bank Advisory Committees); bondholder claims are usually settled through debtor government offers to exchange new bonds often having lower value for defaulted old bonds (if enough bondholders accept the swap, as stipulated in the bond contract, it becomes valid); finally, decisions to reduce obligations to IFIs — available only to the poorest countries — are taken by the donor-dominated governing boards of the institutions. Will the total amount of relief add up to what the debtor country economy needs in order to have a fighting chance to grow, create jobs, service its remaining debt normally, and move toward eradicating poverty? Or, will the debt workout give the debtor country just enough relief to return to full debt servicing with little budgetary room left for public investment and essential social services? Unfortunately, the experience over the past quarter century has been more the latter than the former.

While the IMF has usually assumed the role of international arbiter of how much relief, new financing and policy reform a country needs to overcome its debt crisis, it has been widely accused of systematically underestimating the amount of relief needed. This could reflect an institutional optimistic bias, since its needs assessment for a country is based on the outcome promised when the country follows the IMF's policy advice. In addition, it is only fair to note that the IMF as an institution does not control any of the creditors that are expected to take losses from debt relief and its ability to influence them varies. Each creditor would prefer to collect the most it can of what is owed to it and leave it to the other creditors to take larger losses or leave the debtor to struggle as necessary to make remaining payments. Private creditors have never claimed to be in the business of poverty eradication and one can argue about the relative priority of that goal even among some of the official creditors (e.g., it is not the mandate of export credit agencies whose claims are treated in the Paris Club).

What thus seems to be missing in the financial architecture on sovereign debt is some effective coordinating mechanism, in essence a sovereign analogue to bankruptcy "protection" of corporate debtors (such as chapter 11 of the US bankruptcy code), in which law and precedent guide a judge as she oversees the efforts of the relevant parties to restructure a firm so as to survive while honoring as many of the creditors' claims as feasible. Although several proposals have been made to create a coherent and development-oriented international mechanism for debt workouts, none has won broad

support among governments. Creditors and even the largest debtor governments prefer to take their chances in the existing fragmented system. Perhaps they prefer the "evil they know" to an unknown arrangement, to play the existing game of sovereign debt rather than a new one whose rules they would have to master as they sought strategies to maximize their respective advantage.

If there were a global debt-workout mechanism (a point we return to at the end of this paper), one would want to know not only that it operated efficiently to bring all the relevant parties together and reach an agreement in a timely way, but also that the workout was just. There is no presumption that different players competing to advance their own interest reach a social optimum under the existing debt game. We know vast numbers of people sense the injustice in how sovereign debt has been treated internationally. The strong pressure of the Jubilee 2000 movement to cancel debts of poor countries is strong evidence of that.[8] An international coordination mechanism should aim to do better, but then, what does "better" mean?

A Theological Focus on the Consequences of Over-Indebtedness

That the terms of sovereign debt workouts have improved over time for many of the heavily indebted countries — albeit not fast enough or for enough countries — owes much to the steady and often heavy pressure of civil society campaigns that embarrass creditor governments before their voters and embolden debtor governments in facing their public and private creditors. The civil society campaigns seem to have drawn much of their strength from arguments based on theological reflections on justice and from such global religious institutions as the Catholic Church and networks like the World Council of Churches. Indeed, the rallying cry of the major anti-debt campaign over the past decade has been to call for debt relief in the "Jubilee Year", itself a biblical concept.[9]

The central concern for writers in this tradition has been that sovereign debt obligations can become oppressive and keep or push people in heavily indebted countries into extreme poverty. This is regarded as morally unacceptable. Extreme poverty — especially with the technology available today — is a result of how societies are organized, how the social product is produced and shared among the population. Sovereign debt crises are seen to aggravate extreme poverty or impede efforts to eradicate it. Neither sovereign debt crises nor poverty are immutable facts of nature and one may conceive of ways to eliminate them (especially thinking globally). Since we are

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[8] Illustrative of the pressure is that in September 2000, in the context of the Millennium Summit, Jubilee 2000 presented to the United Nations Secretary-General a petition calling on the leaders of the richest countries to cancel the debts of the poorest. It was signed by 24 million people from 166 countries (see Marlene Barrett, ed., *The World Will Never Be the Same Again* (London: Jubilee 2000 Coalition, December 2000), p. 17 (available at http://www.jubileeresearch.org/analysis/reports/J2REPORT.pdf).

[9] While Christian churches have been centrally engaged in the debt advocacy movement, the movement itself draws strong support from people of other faiths and secular supporters. Without them, the movement would not have achieved even its limited albeit important successes. Nevertheless, much of the rhetoric of the anti-debt movement over the past several decades — and its moral appeal — has drawn importantly from the Judeo-Christian traditions that are the focus of the essays in this section.

instructed by our religions to care about our fellow creatures ("solidarity"), we are *obligated* to work to overcome the debt crises and seek to eradicate poverty. An even stronger view can be found among some theologians, namely, that the bible warns us that a society with extreme poverty (especially when accompanied by extreme wealth) is unsustainable, let alone unjust. Not only *can* poverty be addressed, but also ultimately it *must* be addressed for the survival of the society. Under both arguments, excessive debt must be relieved and a "fresh start" afforded.

Seen from the world of practical politics, these are highly radical points of view. In fact, no debts are relieved except under very extreme circumstances, as under formal "bankruptcy protection", as noted above for the corporate case, when the alternative faced would be closing down the firm (and thus greater losses for the creditors), or socially intolerable pauperization in the case of a household. There is nothing comparable to bankruptcy for sovereign governments, where the alternatives are limited to redirecting more public expenditure to the creditors, raising more tax revenue for the creditors, or reducing the government's debt obligations. Moving international policy even part way towards the last option has required prolonged and intense advocacy by millions of people around the world. Something very powerful must have been motivating them, something very appealing in the core idea of the "fresh start".

An Interpretation of the Judeo-Christian Tradition on Debt

Ton Veerkamp, a founder of Kairos Europa[10] traces the origin of the "fresh start" case for debt relief back to biblical calls for periodic household debt forgiveness in "Jubilee Years."[11] The most striking aspect of his view is that the Jubilee idea not only spoke to some innate sense of fairness, but also and more importantly would have served the crucial political function of maintaining social cohesion in the small-scale and basically stateless society of ancient rural Judea during the time of the exile of the Jewish elites to Babylon. That is, periodically forgiving all debts — and not only the debts of the poorest households — would reverse the increasingly unequal income and wealth distribution that the normal operation of the economy generated. Veerkamp notes that, whether or not the principle was actually applied (which we do not know), it was decidedly not applied during periods of strong states, whether in the earlier Davidic kingdoms or when the ancient Jewish people were under the Greeks or Romans. State power can and does sustain radically unequal wealth, at least for a time. In that reality, the biblical prescriptions for income and wealth redistribution survive only as ethical maxims, albeit, we might add, compelling ones for many, many people.

Veerkamp goes on to argue that it is possible even in modern times for the redistributive principles to be made into policy through politics. He warns, however, that

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[10] Kairos Europa is an ecumenical network critical of neoliberal globalization that aims to stimulate the participation of churches in a "conciliar process of mutual commitment to justice, peace and the integrity of creation" (Ulrich Duchrow, "God or Mammon?" Soesterberg Consultation on the Economy in the Service of Life, June 2002, available at http://www.warc.ch/pc/soester/07.html).

[11] See "Judeo-Christian Tradition on Debt: Political Not Just Ethical," in Barry, Herman and Tomitova, op. cit.

this is not easy. He recounts how people with different economic interests tend to fruitlessly talk past each other, often invoking different moral principles and perhaps not even understanding — let alone appreciating — the views of the other side. Whether or not mutual learning is possible, political pressures can force policy change. Veerkamp thus for many years joined with the World Council of Churches and other networks and institutions in calling for organizing masses of people around the world to create precisely this political pressure to change policies on the treatment of debt crises.

He acknowledges, moreover, that politics is not for the faint hearted. It is messy in a way that "a purely individualistic ethic must always find embarrassing," using the terminology of the American theologian, Reinhold Niebuhr.[12] Veerkamp describes as a case in point the debt policy of Nehemiah, governor of what was at the time the Judean province of the Persian Empire. Nehemiah faced a debtors' political movement that he could either attempt to suppress or accommodate. He opportunely chose the latter.

Veerkamp would apparently like to see the international movement for debt relief — Jubilee and its successors — become powerful enough to bring about sufficient debt cancellation for poor countries and give them the kind of "fresh start" that the biblical authors talked about giving to families in ancient Judea. He says we need it today for the same reason the Jewish people needed it then: a world of sovereign states as unequal as ours is now, tolerating extreme poverty, is ultimately unsustainable.

Catholic Church Activism on International Debt

Members of the Catholic Church have been strongly involved in the Jubilee Movement from its early years in the 1980s through the Millennium Year and beyond. Many in the Church leadership, including Pope John Paul II, spoke out for its principles, prepared formal statements in response to it, and pressed Catholic political and financial leaders to take it into account. Elizabeth Anne Donnelly, an American activist in Catholic social movements, has traced the development of Catholic involvement in the international policy response to developing country debt crises, starting from its origins in the concerns expressed to Church leaders by social service agencies and missionaries in heavily indebted developing countries in the 1980s.[13]

Through an analysis of two prominent 1980s statements on the debt crisis — one by the Pontifical Commission on Justice and Peace (1987) and the other by the United States Conference of Catholic Bishops (1989) — as well as reflecting on Catholic social teachings that underlay these statements, she emphasizes the social imperative that in Catholic religious tradition is called "exercising a preferential option for the poor." That phrase, however, seems open to wide interpretation. Donnelly interprets it as meaning that when economic or political institutions exacerbate poverty, they should be recognized as "institutionalized violence and social sin" and should be "addressed."

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[12] Reinhold Niebuhr, *Moral Man and Immoral Society* [1932], New York 1960, p. xi, as cited by Veerkamp, op. cit.

[13] See "Making the Case for Jubilee: The Catholic Church and the Poor Country Debt Movement," *Ethics and International Affairs*, op. cit.

Others might consider that holding private or even public financial institutions to such a standard is quite a radical idea.

The core implication of the "option for the poor" as regards external debt of developing countries is that it directly links debt relief and poverty alleviation. To the extent that honoring debt obligations impeded the ability of countries to overcome extreme poverty, the debt was a problem that morally cried out to be addressed. One could add that the developed country governments and IFIs accepted the rhetoric of this approach in adopting their Heavily Indebted Poor Countries (HIPCs) Initiative, in which the promise of "adequate" debt reduction was coupled with debtor country commitments to develop "poverty reduction strategies" in consultation with their civil society organizations. Unfortunately, when it came time to operationalize the Initiative, the developed countries did not reduce the total amount of debt by enough to put the poorest countries into a "sustainable" debt situation, as defined by the creditors themselves.

While the goal of debt relief seemed broadly analogous to the "fresh start" of the biblical principle, the inadequate amount of debt cancellation was repeatedly associated with the still inadequate levels of education and health spending. Again and again, since the HIPC Initiative was first launched in 1996, civil society movements brought widespread public attention to the creditors' miserly approach to relief. Each time some additional relief was forthcoming. Most recently, in 2005, this took the form of the Multilateral Debt Relief Initiative, which eliminates most remaining external debt obligations of a group of HIPCs, aimed explicitly to help them achieve the Millennium Development Goals (MDGs), the first and foremost being to halve extreme poverty by 2015.[14]

Achieving the MDGs is not only for the poorest countries. Those countries that have managed to sustain a strong rate of economic growth, most notably China and India, are likely to succeed. Those that recently underwent financial crises face a greater challenge. Argentina is a case in point and it is one in which the Catholic bishops became more actively engaged as the crisis deepened. In the view of Thomas Trebat, Executive Director of the Institute of Latin American Studies at Columbia University and a former managing director and head of Latin American economic research at Citigroup, the Catholic Church served as a credible institution in the midst of Argentina's political and economic collapse and helped to facilitate — if "after hesitation and misgivings" — a broad national dialogue of government and civil society.[15]

The Argentine story is particularly interesting because the Church there has a history of association with the business and political elite. Apparently, a number of Argentina's bishops increasingly lost patience with them and the rigid policies they persisted in following at great economic and social cost. Trebat notes that at one point in 2000 the Argentine Church supported a protest march led by dissident union leaders against the IMF, which had endorsed and financially supported the policy rigidities. By

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[14] See United Nations, *Millennium Development Goals Report, 2006* (New York, United Nations, 2006), available at http://unstats.un.org/unsd/mdg/Resources/Static/Products/Progress2006/MDGReport2006.pdf.
[15] See "Argentina, the Church and the Debt," *Ethics and International Affairs*, op. cit.

the end of 2001, when the financial collapse finally came, Argentina had been in recession for 45 months. Church criticism focused on the damage done to Argentine society as a whole, as well as to the poor in particular.

This notwithstanding, the Argentine Church was not the Jubilee Movement. It sought to occupy a middle ground between the religious debt campaigners and the creditor interests. As Trebat reports, the Church called on the Administration of Nestor Kirchner to negotiate in good faith with Argentina's creditors and also expressed concern for some of the holders of defaulted Argentine bonds, including Italian households. It accepted the legitimacy of Argentina's debt and the presumption it should be paid. But the Argentine Church also asserted a moral presumption that substantial relief was warranted in this case owing to the cost already paid by Argentine society from having tried to service its debt.

Trebat sees two lessons in the Argentine episode. First, creditors of emerging market governments should appreciate that "once a reasonable effort to repay has been made, demands for repayment according to strict contractual terms may be legal, but not morally defensible." There is — and should be assumed to be — a risk in lending to sovereigns. Second, Argentina's elites "must be cognizant that theirs is a profoundly unjust society and that priority in matters of debt must be given to human development rather than blind adherence to what the bishops called 'the tyranny of the markets'."

Implications: The Post-Jubilee Advocacy Agenda

In sum, in Argentina as in the HIPC Initiative, the "ethical" became "political," as Veerkamp might say. However, the tension has remained palpable between the efforts of the debt campaigners to bring about major relief versus the efforts of many of the creditor authorities to simply coop the language of the Jubilee campaign without adopting its policy prescriptions. Debt activists consider they have much still to accomplish. First, governments whose debts were cancelled must be monitored and pressed to redirect freed up resources to poverty alleviation. Second, the principle linking adequacy of debt reduction to achieving the MDGs needs to be extended to all countries needing it, not only the selected HIPCs. Finally, as Donnelly concludes, since the central issue is poverty, the focus on debt needs to be complemented with strong attention paid to trade and foreign aid policy under such broad banners as "Make Poverty History."

In other words, the theologically oriented arguments presented in this section have asserted that because suffering from extreme poverty is unconscionable and unwise (as it is ultimately unsustainable politically), the economically powerful states of the world should accord developing countries a "fresh start" whenever it is observed that the external sovereign debt of those countries holds back their ability to overcome poverty. This call for debt relief applies firstly to defaulting governments, because default brings on a major financial trauma with severe social consequences. It is not a step taken lightly. But by the logic of the argument, it should also apply to countries that meet their debt-servicing obligations at great social sacrifice. Admittedly, every government is responsible for how it raises and budgets its resources and so there may well be non-debt-

related reasons for short-changing anti-poverty expenditure. Thus, decisions on which countries should get how much relief has to be open to interpretation. Nevertheless, the commitment of all the world's governments to achieve the MDGs by 2015 adds a degree of concreteness to governmental and intergovernmental obligations: relief should be accorded to every country in danger of not achieving the MDGs owing to external debt servicing.[16]

In short, the authors discussed here that draw on the Judeo-Christian tradition view debt in an instrumental way, as a factor affecting poverty and social cohesion, which is their main concern. This implies that when debt cancellation is warranted, it should be delivered so as to effectively address the wider anti-poverty imperatives. The implications are systemic: first, the debt relief process described earlier should be restructured so as to take proper account of the potential anti-poverty impact (Who, after all, speaks for the poor in the various sets of negotiations outlined earlier?); second, effective processes are needed for monitoring that the relief is in fact translated into appropriate public expenditure (Who insures government accountability to the poor?); and third, debt relief must be seen as but one instrument among many that can be brought to bear in the struggle to bring about a more just world (If developed countries fully opened their markets to the exports of developing countries, would so many countries even need to seek debt relief?).

A Philosophical Focus on Responsibilities of Parties to Loans

As we have seen, a strong case can be made for canceling the foreign debts of the government in a poor country when they cause or contribute to significant hardship of the people. This entails, of course, imposing a loss on the creditors. We may not feel much sympathy with rich creditors, for whom the loss might be minor. However, do we feel differently if we realize that the ultimate creditors are not the owners of faceless institutions behind marble walls, but people like ourselves? After all, "we" lent that money in good faith.

The universal presumption in legal affairs is that every loan agreement should be honored (*pacta sunt servanda*); each loan should be repaid with interest on schedule. But debt contracts, like virtually all contracts, routinely have clauses dealing with how to handle the situation when one or another party fails to fulfill its obligations under the contract. The ability to fulfill such an obligation may be compromised by any number of eventualities and the contracting parties need to agree beforehand how to respond to such cases, or how to go about deciding how to handle such cases (e.g., to resolve the problem in a court of law or by arbitration).

[16] This point was acknowledged — if not acted on — by the 2005 World Summit of the United Nations, when the assembled heads of state and government underlined "the importance of debt sustainability to the efforts to achieve national development goals, including the Millennium Development Goals, recognizing the key role that debt relief can play in liberating resources that can be directed towards activities consistent with poverty eradication, sustained economic growth and sustainable development" (General Assembly resolution 60/1, para. 26 (b)).

The ethical question in this context can be framed in terms of what a just set of relationships would be between borrower and lender. What would a just loan contract look like and what should parties to a loan do if they wanted to act justly? Writers who raise such questions ask, in other words, what *should* be the legitimate expectations and responsibilities of the different parties agreeing to the loan and what should be done when the government's debt — the result of a series of loan contracts with different creditors — cannot be serviced as contracted.

Christian Barry and Lydia Tomitova of the Carnegie Council for Ethics in International Affairs approached this problem by asking when does a sovereign have an "ethical obligation" to repay a debt and when should it honor that obligation?[17] "Obligation" in this sense speaks to a relationship between the parties to a loan; "honoring the obligation" speaks to actions taken or not to make a payment at a particular time. The authors approach these separate questions by asking, under what circumstances *ought* a borrowing government repay, when might it *permissibly* repay and when *ought it not* repay a debt. The answers are complicated, as sometimes a government ought not to repay a debt even though obliged to repay (e.g., if honoring a commitment to pay would impoverish the population, which is to say when an obligation not to impoverish overrides the obligation to the creditor). Also, the authors see cases in which a borrower ought to repay even if it has no ethical obligation to pay (e.g., even if the loan was immoral in some sense, the government might pay to maintain its credit standing among potential lenders, a strategic objective so as to hold down future borrowing costs). By the same token, creditors sometimes ought to demand repayment, might permissibly demand repayment or ought to forgive repayment when the debtor has an ethical obligation to repay and even when there is no such obligation.

The authors' strategy for sorting through these possibilities is to posit idealized conditions under which loan contracts in general between any two parties should be enforceable, and then asking how this informs a discussion of sovereign debt. Their idealized conditions are that (a) the contracting parties should be rational agents who are willing (and implicitly, able) to bear the full risk of loss to get the potential gain from a loan; (b) both are "formally free," so that neither has the right to dictate the terms of agreement; (c) both are "substantively free," so that neither can effectively dictate the terms of agreement to the other; (d) both have the information they need and are competent to assess the prospective contract; and (e) the environment in which the contracting parties operate is "relatively stable" so few "unforeseeable changes" occur.[18]

These criteria are held to be attractive because, when they obtain, parties would make only mutually beneficial loans. Also, as these loan contracts would be legally enforceable, it would discourage parties from breaking the contract (they would be held accountable). Moreover, under these criteria, rich people would have the confidence to lend in the first place, permitting the more efficient allocation of financial resources and more economic growth. In addition to such "consequentialist" considerations, Barry and

[17] See "Fairness in Sovereign Debt," *Social Research*, vol. 73, No. 2 (Summer 2006), pp. 649-694.

[18] The difference between (d) and (e) can be interpreted as taking account of the difference between evaluating known or knowable risks owing to the normal variability of economic activity versus uncertainty about economic "shocks" that are by nature surprises.

Tomitova are attracted to these criteria for so-called "deontological" reasons, i.e., because they would give opportunities for people to develop their sense of duty and act ethically. The authors see the process of borrowing and repaying as encouraging personal ethical development (becoming a "person of integrity").

Barry and Tomitova then ask how much of this applies at the level of sovereign borrowing in the world, as it exists. Their answer is, alas, not enough. To start, sovereign debtors are not individuals but complex collections of individuals, some of whom usually count much more than others. Also, the borrowing government may be formally free, but far from "substantively free." In addition, borrowers may not fully appreciate the risks they enter into when borrowing (and one could add that sovereign borrowers and their creditors have at times taken on excessive risks on the assumption — true in some years and false in others — that they would be bailed out by the official international community). Finally, the global economic environment has been more volatile than expected in recent decades and subject to major uncertainties.

This seems a sensible framework. Does it help us figure out where justice lies in resolving a sovereign debt crisis?

Responsibility of Debtors

One may ask if in practice there are circumstances in which the creditors have a moral claim to be paid in a sovereign debt crisis, acknowledging that the burden might be born by the residents of a low-income country in difficulty. When should the debtors be held responsible?

A first presumption might be that those responsible for undertaking the debt are obliged to repay it. In other words, one could argue that citizens of a democracy should pay because they are responsible for acts of their government, including signing loan contracts. But this is not as straightforward as it seems. Sanjay Reddy, an economist at Barnard College, notes in this context that at any moment in time, including the day a loan contract is signed, the state represents a collection of individuals who are at different points in their life cycle, including, of course, some yet to be born who will be affected by the terms of the loan.[19] Thus, democracy per se cannot be an effective criterion for sovereign debtor responsibility to repay any long-term loan, as the unborn cannot vote.

Reddy argues that the state can nevertheless morally bind its ongoing collective of people in the country to repay its debt. He posits that the collective would be morally bound to repay if the people in the country "equitably" share the benefits and costs of the debt (satisfying some agreed distributional criteria, as on fairly sharing the tax burden for repaying and deciding how or where in the country the proceeds of the loan would be spent and the benefits of the loan captured), assuming also that the overall outcome is "beneficial" for the country (again, satisfying some agreed meaning, as in terms of economic growth). In other words, creditors could fairly demand repayment from the

[19] See "International Debt: the Constructive Implications of Some Moral Mathematics," *Ethics and International Affairs*, op. cit.

state when it contained net beneficiaries of the loans and the distribution of the net benefits had been fairly arrived at. Reddy thus takes us to a point of intersection with the theological arguments discussed earlier. The call of the latter for debt cancellation posited the negation of the conditions warranting repayment, i.e., when debt servicing impedes achieving the Millennium Development Goals. This conclusion hinges, in Reddy's terms, on the negative impact of debt servicing on the poor and the lack of fairness when the prospective benefits of the loans were allocated in the first place.

Implicit in Reddy's argument is not only that the state should be willing to pay when there are net benefits of the debt, but that it has the ability to repay. But should the debtor state have to repay even if there were no net benefits of the loans? The nature of a debt contract is to put all the risk on the borrower: even if the project for which the funds were borrowed fails, the borrower is still expected to repay the loan. Reddy attempts to address this problem by calling for "modified debt contracts" that entail claims for repayment and interest that are contingent on the outcomes realized from the loans.

Unfortunately, creditors have generally shown little interest in any such "modified debt contracts", outside of Islamic finance.[20] The major instances in which the market has accepted sovereign loans with built-in contingent payments have been as part of debt restructuring negotiations, which were not unconstrained choices. In those arrangements, payments depended in part on the international price of a major export commodity, in particular, crude oil (e.g., Venezuela and Nigeria) or on growth of gross domestic product (Argentina). By the same token, sovereign borrowers with normal market access have not shown interest in issuing modified debt contracts, even though it appears to be in their interest to do so. This is not to deny that the debt management offices of some developing countries have used privately issued derivative financial instruments to shift some of the risk of their standard ("plain vanilla"), fixed-coupon bonds in dollars or some other international currency to investors who would accept these risks at a price. However, they have not sought to build such risk mitigation features into the bonds themselves. Public sector and academic efforts to promote development of such instruments have so far been treated as interesting curiosities.[21]

We are thus stuck with the question of the ethics in servicing standard sovereign loan contracts. Alexander W. Cappelen, Rune J. Hagen and Bertil Tungodden, three Norwegian scholars, asked is it not important to inquire who caused the debt crisis before giving debt relief. [22] How much should the creditors have to forgo if the losses — and poverty — of the borrower was its own fault? Is there not a proper notion of "national

[20] Islamic finance prohibits fixed interest loan contracts (see, in the sovereign context, Nadeem ul Haque and Abbas Mirakhor, "The Design of Instruments for Government Finance in an Islamic Economy," IMF Working Paper, March 1998).

[21] There are, to be fair, some technical difficulties in issuing such securities, such as appropriately pricing them in the market, owing to the uncertainty of their returns. See United Nations, Financing for Development Office and United Nations Development Program, "Report on the Brainstorming Meeting on GDP-Indexed Bonds: Making it Happen, New York, October 31, 2005" (available at http://www.un.org/esa/ffd/IntergovernmentalFollow-Up/CivilSoc&BussSec/BusinessSector/GDP-indexed%20bonds%20Report.doc).

[22] See "National Responsibility and the Just Distribution of Debt Relief," *Ethics and International Affairs*, op. cit.

responsibility" of sovereign debtors and their people?

Cappelen and his colleagues invoke a "liberal egalitarian" framework in their discussion, which seeks to distinguish when persons or institutions should be held responsible for their situation and when not. Under this framework, inequalities that result from "responsibility factors" are considered justified and thus should be socially accepted (principle of responsibility). In such a case, the citizens of a poor country — albeit not necessarily the poorest among them — should pay the government's debt. However, inequalities for which agents are not responsible are considered not justified and should be eliminated (principle of equalization). In such cases, debt cancellation is warranted. Responsibility presupposes that national policies are freely formulated and democratically adopted (as it can be argued was the case in Argentina, but may not have been the case in many other developing countries). Further, as there is much uncertainty and volatility regarding how policies turn out, they argue that agents should only be held responsible for the "fair consequences of borrowing."

The authors then ask if there is evidence that such a framework has been used in according relief to the HIPCs, the group of heavily indebted poor countries singled out for special debt relief treatment. Their answer is no. They find that the amount of relief given to these countries is statistically related to the amount of debt accumulated but not to the degree of poverty in the country. If poverty was a non-responsibility factor, creditors should have forgiven relatively more debt in poorer countries. Instead, the results seem to conform more to the theologians' argument for a "fresh start" discussed earlier, wherein one would seek to bring each crisis country to a point where it had a fair chance to succeed economically. More indebted countries would require more relief to get to this fair starting point, regardless of who was at fault or whether there was a large or small amount of poverty. In this perspective, the amount of relief should be a function of the amount of indebtedness, as was found, and not the extent of poverty.[23]

It appears from this discussion that the theologians' approach to debt is the opposite of the liberal egalitarian one. The biblical periodic cancellation of debts made no reference to who was at fault in the accumulation of the unpayable debt. Indeed, all debts were to be cancelled, even payable ones. In Veerkamp's view, this was to prevent society from becoming too unequal, the rich too rich as well as the poor too poor. In the discussion by Donnelly, the focus was more on the impulse of solidarity to alleviate the suffering of the poor. To Trebat, the limit had been reached on how much punishment the Argentine people should be allowed to sustain in trying to service the debt. And in all variants of the theological approach, individual or national blame for the debt is beside the point. The perspective of the "fresh start" is forward looking.

Responsibility of Creditors

If the argument that debtor governments should be held responsible for their debt crises has not been reflected in international debt relief policy, neither has the argument

[23] This does not imply donor insensitivity to poverty, as foreign aid, unlike debt relief, could be allocated according to the extent of poverty.

that creditors should be liable for damages caused by their loans or the policies they required of governments to get the loans. Kunibert Raffer, a lawyer and economist at the University of Vienna, makes the case for lender liability.[24] In fact, he charges that Southern governments that entered into debt crises after 1970 have born a higher and disproportionate share of the cost of default than have their creditors compared to the experience of debtor governments over the previous century. He also believes that sovereign debtors have been treated worse than corporate debtors, owing in part to the absence of a legal bankruptcy regime for governments, as there are protections for the debtors (as well as the creditors) in bankruptcy laws. He blames these results on the great disparity in economic power between the developing country debtors and their different international creditors, which is illustrative of what Barry and Tomitova in the paper discussed above referred to as the problem of "substantive freedom" in borrowing, or rather the lack thereof.

Raffer emphasizes that lenders should be held liable for sovereign default when their actions impede the debtor from honoring its obligations. He gives as an example of such a case when debtors cannot raise sufficient tax revenue to service their debt because of artificial restraints on their country's exports (and thus income) owing to tough import tariff and quota restrictions on the goods in which the debtor economy has a comparative advantage.[25] In the same vein, the major international commercial banks are accused of having abetted the difficulties that developing countries had in servicing their debts to those banks in the 1980s, as their private banking arms helped rich nationals remove their financial resources (capital flight), while their sovereign lending arms kept extending loans that were ultimately unpayable.

Raffer is particularly concerned about the behavior of the IFIs, which insist on being the first in line to be repaid while pushing debtor countries to adopt policies that he alleges have contributed to the debt crises. He cites cases in private law in which debtors did not have to repay creditors that misled them. Nothing of the sort is available to sovereign debtors under international law. No one but the debtor pays for mistakes at this level. He argues not only that this is wrong, but also that each of the IFIs has the legal and financial ability to grant relief through its normal decision-making processes and so could take financial responsibility when its advice proved misguided.

Raffer further argues that better recognizing lender responsibility is not only important for making international financial relations fairer, but they would also lead to better decisions. Giving debtor governments the opportunity to claim that responsibility for a crisis should be shared with the IMF or World Bank should make the institutions more cautious in pushing on governments whatever the current policy fad happens to be. By the same token, the possibility that any of the creditors could be held liable should make the "due diligence" expected of all creditors individually into a better mechanism for crisis prevention.

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[24] See "Risks of Lending and Liability of Lenders," *Ethics and International Affairs*, op cit.

[25] That the creditor country might have a good and sufficient reason for its trade restrictions would not reduce its liability, in Raffer's eyes, as the debtor country was not party to the trade distorting decisions.

This line of argument also leads one to think about how other types of creditors might be encouraged to lend "better" by shouldering more responsibility for their loans. For example, export credit agencies have been accused of promoting sales of goods that developing countries do not need.[26] Indeed, in October 2006, the Norwegian Government decided to "share responsibility" for loans originally incurred to cover the purchase of Norwegian ships during 1976-1980 by 21 developing countries in a campaign that was discredited in an official evaluation in 1988-89 and that the current government considered a "development policy failure"; it thus cancelled $80 million remaining due from five countries.[27] The principle could be internationalized. That is, the Organization for Economic Cooperation and Development (OECD) in Paris hosts an intergovernmental Working Party on Export Credits and Credit Guarantees that has already inscribed "debt sustainability and responsible lending" on its agenda. This forum could develop an agreed definition of "irresponsible" lending and members could then promise to eschew making such loans and not hold borrowing governments responsible for repaying such loans if they are made. While borrowing governments might anyway choose to service such loans (an instance of deciding to pay when not having an obligation to pay), in the event of default one may be confident that these loans would be accorded lower repayment priority than other debts of the government.

Implications: Broader Responsibilities in Loan Agreements?

Several policy questions are raised by the preceding discussion, including how to help developing country governments become better borrowers, how better to handle international volatility and uncertainty, and how to hold creditors (and debtors) to account when they contribute to sovereign insolvency. International technical assistance programs in debt management and public finance contribute to the first goal. Volatility and uncertainty have mainly been addressed outside the debt contract per se, as in programs of compensatory official financing to ease the impact of international commodity price volatility.[28] The last point, defining more clearly what should be the responsibilities of different agents in debt contracts, has not seen very much policy follow up thus far, although the recent attention paid to "odious" debt and the Equator Principles may be interesting straws in the wind.

Unlike government regulation of the consumer market for loans and national bankruptcy laws, there is no internationally agreed "truth in lending", nor are their other international rules or guidelines for sovereign debt. There are only specific contractual obligations in individual loans and the uncertain treatment of those contracts in different

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[26] The following point was developed in the workshop discussion of an earlier draft of this paper at Central European University, October 26, 2006.

[27] See Eurodad, "Norway Makes Ground-Breaking Decision to Cancel Illegitimate Debt" (including official Norwegian Government press release), October 10, 2006 (available at http://www.eurodad.org/articles/default.aspx?id=737).

[28] Significant contingent financing programs were introduced decades ago by the IMF and the European Union (the latter including grants for the poorest countries when commodity export prices declined significantly), but were subsequently weakened or retracted in the 1980s and 1990s, although they have seen a partial rethink in the current decade, if only for the poorest countries.

national courts of law. There is, however, one example of supra-contractual international policy embodied in a small set of cases in which the political authorities of a state have, in essence, repudiated or forced the cancellation or restructuring of their own or another county's debt obligations based on the assertion that the government that incurred the debt had carried out "odious" actions against its own people with funds that the creditors helped to provide.[29]

Under this doctrine, a sovereign government's debt may be defined as "odious" if the funds were borrowed by a government that lacks "legitimacy" in some sense, if they were not borrowed for a public purpose (i.e., not to benefit the people in some sense), and if the lenders were aware of both conditions when they made the loans. The doctrine then says that a legitimate successor state need not repay such odious debts. The doctrine was most famously applied by the United States after the Spanish-American War of 1898 to explain why the new government of Cuba should not be held responsible for the debts incurred when it was under Spanish control. The doctrine was also cited recently in arguments why the current Iraqi government should not have to repay the creditors of the former Iraqi regime. It has to be noted that US authorities made the case for both Cuba and Iraq at times of strong US interest (and military involvement) in each place. It is an argument meant in these cases to punish creditors (or their government patrons) for abetting the odiousness of a government that has fallen, as much as to help the new government.

Several civil society advocacy groups have also used the argument to call for cancellation of the debts that new democratic governments in some developing countries inherited from their non-democratic predecessors. However, these governments — especially those in fragile, new democracies — seem most intent on knitting their society back together and re-establishing normal international relations, including with prospective creditors. A case prominently discussed among civil society networks was that of South Africa.[30] Just as its post-apartheid government wanted "Truth and Reconciliation," not new Nuremburg Trials, so too it wanted investors — domestic as well as foreign — to be fully confident that the South African government would honor its debt obligations without interruption. The South African authorities rejected calls to nullify the debt on the basis of its odiousness. Efforts by international advisors and civil society advocates to convince new regimes in other countries to make the case for odious debt cancellation have similarly been rejected by debtor country finance ministries.

Debtor governments clearly appreciate that all the risk falls on them if they initiate a claim that the debts inherited from a previous regime are odious and should not be honored. Should they unilaterally repudiate the debts, they may be frozen out of future funds. If they plead their case to the international community, they may receive only a sympathetic hearing, when what they need is some form of statement that would be

[29] See Ashfaq Khalfan, Jeff King and Bryon Thomas, "Advancing the Odious Debt Doctrine," Working Paper, Center for International Sustainable Development Law, Montreal, March 11, 2003. (available at http://www.odiousdebts.org/odiousdebts/publications/Advancing_the_Odious_Debt_Doctrine.pdf)
[30] See "South Africa: Campaigns, Essays and Reports, and News Articles" and references cited therein on the odious debt web page of Probe International (http://www.odiousdebts.org/odiousdebts/index.cfm?DSP=subcontent&AreaID=159).

acceptable to the government agencies, multilateral institutions and courts of the creditor countries saying that payment of those debts was not required.

The risk could be reduced if an anti-odiousness pledge were written into the loan contracts.[31] It would then be a matter of determining whether an odious situation had occurred, not whether odiousness would be an acceptable condition for non-payment. This presupposes an internationally agreed definition of odiousness and an international mechanism to judge individual instances of externally financed odious behavior (not to mention including enforceable legal covenants in the loan contract protecting the claims of the non-odious creditors of an odious debtor). Such a project would entail a very ambitious international negotiating agenda. Yet it suggests that a contractual approach might be devised in conjunction with international political action to move creditors and debtors to accept broader responsibilities for their loans.

In this regard, a potentially important precedent is being established by the revised "Equator Principles" for preventing negative environmental and social impacts of large-scale projects financed by commercial banks. While banks voluntarily adopt the principles, pressure within the industry and from civil society organizations has spread adoption to 41 institutions responsible for some 85 percent of private cross-border "project finance" (although the degree of implementation by participating banks is apparently less than clear). Of particular relevance to the present discussion, institutions subscribing to the revised principles are now required to include compliance covenants in their loan agreements, including borrower promises to implement "Action Plans" that are prepared according to specified procedures in order to mitigate potential adverse impacts of a project and to report on implementation periodically. If the borrower fails to comply, the lending banks "reserve the right to exercise remedies, as they consider appropriate."[32] It remains to be seen what such "remedies" might be and how transparent the whole process will become.

This initiative understandably has its critics as well as supporters,[33] but is nonetheless interesting for directly acknowledging that there is an issue of creditor and debtor responsibilities for what is done with borrowed monies. Also, while the principles were designed with an eye on and to complement the "Sustainability Policies" — also revised in 2006 — of the International Finance Corporation, the private lending arm of the World Bank, there is no international agreement endorsing or overseeing the principles. They are thus a test of how far a purely voluntary contractual approach can go in development of what we may call ethical standards in lending. Finally, one may note that the banks, which are, after all, agents of their depositors and shareholders, developed the Equator Principles as a response to pressures that they exercise more responsibility in

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[31] See Adam Feibelman, "Contract, Priority and Odious Debt," *North Carolina Law Review*, forthcoming in 2007.
[32] "The 'Equator Principles': A Financial Industry Benchmark for Determining, Assessing and Managing Social and Environmental Risk in Project Financing," July 2006 (http://www.equator-principles.com/documents/Equator_Principles.pdf), Principle 8: Covenants.
[33] See, for example, Stephen Kass and Jean McCarroll, "The Revised Equator Principles", *The New York Law Journal*, September 1, 2006 (as posted on the web page of Carter Ledyard & Millburn, LLP at http://www.clm.com/pubs/pub-6107356.html).

their lending than just assuring that the borrower will repay.

An Extension of "Responsibility": Odiousness as a Sanctions Regime

Some authors have taken the responsibility concerns elaborated in the previous section and proposed that they be made operational in a different way, as a sanctions regime to change the behavior of rogue governments. Internationally agreed trade sanctions were viewed for a time as a promising way that the collectivity of nations could isolate a country that threatened its neighbors or seriously violated agreed principles of human rights, democracy and development. In practice, trade sanctions have been a blunt instrument. To the extent they are effective, trade sanctions cause economic disruption, close factories and impoverish people. Moreover, trade sanctions create strong incentives for evasion, as the rich will pay high prices for prohibited imports. This means that the sanctions harm poor people disproportionately. Better targeted sanctions were possibly an answer and this brought some attention to financial sanctions, especially if they could be aimed directly at the offending government.

In this context, Thomas Pogge, a philosopher at Columbia University, has asked if there were not times when a government's ability to borrow abroad should be curtailed by other countries.[34] Interestingly, he turned the sanctions question around and asked first what could a fledgling democracy do to protect itself from a potential *coups d'état*. His answer was that it could try to make it harder for an undemocratic successor regime to operate, as by discouraging new foreign lending to that regime. To be effective, however, his proposal would also require broad international cooperation, as in more conventional sanctions regimes.

Pogge suggested that fledgling democracies amend their constitutions so as to provide that debts incurred by any undemocratic successor regime not be serviced out of the nation's public funds. As the phrase "undemocratic regime" could be open to interpretation, he proposed that the amendment specify that an external entity determine when the regime had crossed from democratic to non-democratic. He further proposed that that entity be an independent "Democracy Panel" and that it be formed from reputable and knowledgeable jurists, possibly under the auspices of the United Nations. His intention was that there would be an expert assessment rather than a political one that the country is no longer democratic.

Pogge expected the leaders of a coup to suspend or annul the constitution, thus permitting continued debt servicing during the new regime, a practical *quid pro quo* for obtaining (and servicing) new credit. Creditors would have to be concerned, however, that democracy and the constitution might be restored and the servicing of loans made during the non-democratic period discontinued, to compensate for which they would typically add a premium to the interest rate on any such loan. Thus, foreign credit would be more expensive and of uncertain availability to an odious regime, at least private credit. Indeed, one could take the argument further and call on creditor governments to

[34] See "Achieving Democracy," *Ethics and International Affairs*, vol. 15, No 1 (2001), pp. 3-23.

cease providing their usual guarantees for export financing and not approve any IFI loans to any regime that was declared non-democratic by the Democracy Panel.[35]

Pogge was quite concerned, however, that his proposal was too radical and that the major democratic regimes would be less anxious to promote fledgling democracies than to maintain international financial rules. One could add that foreign policies *vis-à-vis* individual governments seem generally driven more by concerns for national advantage than the international spread of desirable principles. As he notes in a different context, in some circumstances, the major powers might prefer a less democratic but friendlier regime to a more democratic and more independent one. However, he believes the proposal could be put into effect even without the support of the major powers, and should be put into effect with their active participation.

Jonathan Shafter, a lawyer and Principal of Boston Provident, an investment firm, further develops the idea of discouraging international access to credit by rogue states as a way to strengthen democratic regimes.[36] While Pogge formulates his proposal as a declaration by an individual legitimate government not to honor financial obligations entered into by an illegitimate successor regime and calls for international support of that declaration, Shafter proposes establishing an international sanctions regime to use against governments that the international community deems odious. As he notes, the United Nations sanctions imposed on South Africa's apartheid regime in 1985 could have included a declaration that any loans extended to the regime would not have to be paid by a proper successor regime. This would have created strong pressure on banks not to lend, as their home governments would have in essence declared that they would oppose attempts to collect on those loans through the courts.[37] This would have greatly strengthened international pressure on the regime.

The author admits, however, that a blanket discouragement of lending to a regime subject to sanctions would be too extreme and could prevent government projects that would benefit the people forced to live under that regime. Creditors might wish to lend for such projects, but they would need some way to determine that the loan actually had a public purpose and be able to prove in the future that it had reason to believe that to be the case so as to avoid the loan being declared "odious" and non-payable. For this reason, the author introduces what he calls the "due diligence" model.

The proposal is that first an international organization be charged to declare countries "odious prone," based on principles of international law given to it. The member states of the organization would make the determination, and so the finding would be political, albeit justified by international law. This is not only a matter of

[35] Moreover, if new loans were denied to such a non-democratic regime, it may be expected that the regime would discontinue servicing the legitimate debts that were still outstanding. Thus, so as not to punish those earlier creditors unfairly, Pogge also proposed establishing a multilateral fund with resources provided by democratic countries to cover the payments to the creditors that the "odious" regime ceased making.
[36] See "The Due Diligence Model: A New Approach to the Problem of Odious Debts," *Ethics and International Affairs*, op. cit.
[37] One could add that banks that did lend would have explicitly worked against their governments' foreign policy, which is terrible public relations, especially for publicly regulated institutions like banks.

pragmatism, but also recognition that there is much room for interpretation in whether a government rules with the "consent" of the governed. Potential creditors would then need to assure themselves through "reasonable due diligence" that the loan they were considering is for a public purpose and they would need to monitor that the loan is actually used in the way envisaged. The international organization would presumably issue guidelines on this. It is proposed in any event that it certify that the creditors' due diligence on a project was adequate for any loan to go forward, based on the model of "no action" letters issued by the Securities and Exchange Commission in the United States when there is concern that proposed transactions might run afoul of regulations. In essence, this puts responsibility for properly assessing the project on the creditors, in exchange for which they can be confident their loan would not be declared odious.

The proposal has many attractive features, but much still needs to be fleshed out, as the author himself concludes. First, should the organization be placed in the United Nations, which is universal but as such often has difficulty in reaching consensus, or should it be in a more homogeneous organization, like the OECD, which brings together the developed country democracies and certain large emerging democracies, like Mexico. It could also be a freestanding organization of "like minded" countries. In addition, decisions would have to be reached on the range of application of the sanctions regime; e.g., should it cover government and IFI lending or only the private sector?[38] Finally, much detailed work is still needed to be able to move from the general prescription of "due diligence" to the legal requirements for deal structuring and auditing. It appears to be, however, a very interesting proposal.

Nevertheless, odiousness is far from ready to enter the toolkit of preventive diplomacy. To start, there is no consensus on the concept of odiousness, or of democracy. Moreover, international intervention on a domestic issue like the form of government in a country has little basis in international law. On the other hand, the world needs a stronger international human rights policy. There is a formal global agreement defining human rights and decades of deliberations, negotiations and legal inquiries on human rights. Might odiousness better be defined by international agreement in terms of major and sustained violation of human rights? Might the world agree to international interventions to stop such human rights abuses? Might not the models of Pogge and Shafter help shape a tool of diplomacy that is more than a non-binding resolution expressing outrage, better targeted than trade sanctions, and less destructive than military invasion?

We Still Need an International Forum for the Ethical Treatment of Sovereign Debt

Arguments for relieving developing countries of excessive debt and for distinguishing responsibilities of different parties in a loan are one thing. Turning them into international policy is quite another. That requires having an international forum in which to address these concerns transparently, in a coherent way, and with the participation of all the relevant stakeholders. It does not necessarily mean creation of a

[38] If IFIs were included, it would mean accepting that there were conditions under which IFI loans should not be repaid.

new forum, but it does require a place with a roof, enough seats, and booths for interpreters. One should want, first, a forum that is appropriate for agreeing to a set of principles, such as have been discussed here, and for designing mechanisms for their application. Second, one would want an effective and independent operational arm to apply the principles when and as necessary. This has been and remains a missing piece of the global financial architecture.

Indeed, since the 1980s, different policy writers have suggested introducing into the official international system some mechanism for sovereign debtors that would parallel the bankruptcy laws and their judicial instrumentalities that exist at the national level in most countries. International civil society organizations, such as Jubilee 2000, began to advocate for such a reform of the international financial architecture in the 1990s, but to little avail.

Suddenly, in late 2001 the idea entered the agenda of the IMF and became a serious matter for consideration by policy makers. The staff of the IMF had already been internally considering an institutional model for addressing sovereign bankruptcy when the Secretary of the US Treasury, Paul O'Neill, voiced support for studying such a proposal. The First Deputy Managing Director of the IMF at the time, Anne Krueger, then launched the proposal as the Sovereign Debt Restructuring Mechanism (SDRM) in a speech in November 2001. This was followed in March 2002 when the United Nations Conference on Financing for Development, meeting in Monterrey, Mexico at heads of state and ministerial level, encouraged work to go forward on "an international debt workout mechanism" like the SDRM. The ministerial oversight committee of the IMF in September 2002 then requested that a "concrete proposal" for a statutory SDRM be elaborated for its consideration the following April. The private financial markets mobilized in opposition, joined later by some of the major developing country borrowers and the United States, which had rethought its position under a new Treasury Secretary, John Snow. By the end of April 2003 the proposal was dead.[39]

Up to the moment of its demise, SDRM was hotly debated in multiple conferences in Europe and North America. In one such discussion, Ann Pettifor, former coordinator of the Jubilee Campaign, argued forcefully for an alternative proposal to SDRM.[40] Her proposal for an international institution dealing with debt was based on three principles that seem fully consistent with the analyses discussed in earlier sections of this paper. First, as both debtors and creditors could be held responsible for a sovereign debt crisis, they should share the burden of relief to the extent that each side was "reckless, irresponsible and delinquent." Second, "no one should be judge in their own court," which is to say the judge should not be one of the creditors. And third, the mechanism should be "open, transparent, and accountable to citizens and taxpayers."

[39] For a full post-mortem by a central author of the SDRM, see Sean Hagan, "Designing a Legal Framework to Restructure Sovereign Debt," *Georgetown Journal of International Law,* vol. 36, No. 2 (Winter 2005), pp. 299-402.

[40] "Resolving International Debt Crises Fairly," *Ethics and International Affairs*, vol. 17, No. 2 (2003), pp. 2-9.

The Jubilee framework had been inspired by Chapter 9 of the US bankruptcy code (applying to municipalities and other non-sovereign public entities) and the ad hoc arbitration panels that are formed under the International Chamber of Commerce or other bodies to resolve disputes between direct investors and their host governments. The framework thus called for an ad hoc, independent body, operating under transparent procedures, representing the interests of both the creditors and the citizens of the debtor country. The restructuring plan would be developed by a panel formed for each case, with equal numbers of representatives from the debtor and creditor sides, who would jointly appoint an additional person to act as chair. Pettifor also proposed that the United Nations rather than the IMF should oversee the debt sustainability analysis that would provide the analytical background for the discussion of how much reduction of debt was needed.

Many experts outside civil society circles and some governments, especially in Europe, while considering the SDRM a flawed proposal, advocated further development of the ideas it was meant to address. In fact, not much has happened in this regard since the death of SDRM. Moreover, Argentina showed there could be an advantage to a debtor government in not settling with its creditors all at once in a comprehensive approach. Argentina settled first with the creditors it needed most and let arrears to the others accumulate in an acrimonious atmosphere. Foreign bondholders waited four years for a resolution and then settled for about 27 cents on the dollar.[41] This may not have been a fair apportionment of the relief among the creditors, but that was not Argentina's problem. Market-based solutions are not *ipso facto* fair. Argentina was also not the typical debtor developing country. Its default was the largest sovereign debt crisis in history.

Nevertheless, the case for a statutory approach to debt workouts — even an "ad hoc" and informal mechanism that nevertheless pushes all creditors to work with the debtor for a comprehensive solution — remains as robust as ever. The question was never that a sovereign bankruptcy regime was needed because the current system would fail to produce a solution. No one should doubt that the existing mechanisms will resolve sovereign debt crises, or that the crisis countries that had borrowed from the private markets before will come again to enjoy market access. The concern here is not whether debt crises would be resolved, but whether they would be resolved justly. This involves first the international processes for reaching a just restructuring of the debt, but it also involves, complementing it, as discussed earlier, that there be appropriate allocation and effective monitoring of the cash flow consequences of the relief, which should in any case be part and parcel of the overall integrity of a democratic regime.

Sovereign default is never attractive politically, economically or socially, but sometimes it is necessary, even for well-managed governments. That is the reality of the global economy today as much as it was in the 18th century. Sean Hagan, in his reflections on the SDRM episode, began with a quote from Adam Smith that bears citing as the conclusion of this paper:

[41] There are a variety of estimates of the losses incurred on a very heterogeneous and complex collection of securities; the cited estimate is that of Federico Sturzenegger and Jeromin Zettelmeyer, "Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998-2005," IMF Working Paper (WP/05/137), July 2005.

> “When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor and least hurtful to the creditor.”[42]

[42] Adam Smith, *Wealth of Nations*, Book V, Ch. III, p. 416 (1776), Modern Library Edition, Random House, New York, 1937, p. 883.