

# THE ECONOMICS OF ODIOS DEBT

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## Abstract

CSOs have proposed different policy approaches to protect the population from servicing “odious” debts, i.e. that loans are made to sovereign borrowers that are not used in the interest of the population. This paper raises the question whether the proposed policy approaches would actually achieve their objective. It asks whether the proposed frameworks would indeed make it cheaper for borrowers to repudiate loans deemed odious, analyzing the potential impacts of different frameworks on borrowing costs. The paper concludes that all “odious” debt policy proposals entail significant costs for the borrowing country. Frameworks based on regime-type approaches pose tremendous challenges for the body or bodies charged with adjudicating on the type of regime, and in addition generate incentives for despots to default, especially to those creditors most committed to the goals of the framework. Frameworks based on individual loans entail direct legal costs – whether of auditing loan portfolios and litigating or certifying that each loan complies with the framework’s standards. Ex-ante frameworks appear superior to ex-post ones as they minimize the impact on non-odious governments, although they do not remove all uncertainty: many countries will be penalized for the probability of being declared odious even if they never turn out to be, and worthwhile but risky projects may not be undertaken.

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## I. INTRODUCTION

In recent years, some civil society organizations (CSOs) have stepped up their advocacy for the cancellation of so-called “odious” debts, which may broadly be defined, for the purposes of this paper, as loans to sovereign borrowers that are not used in the interest of the population. They argue that “odious” debts should be cancelled on moral grounds and advocate the implementation of a framework that would exempt the governments that repudiate odious debts from any legal consequences. The aim of this paper is to contribute to a better understanding of the economic implications of instituting such a framework.<sup>1</sup>

All borrowing – whether by governments (“sovereign borrowing”) or private entities – is characterized by at least two potential conflicts of interest (“agency relationships”): the first, between creditors and borrowers, and the second between those responsible for contracting debt and those who ultimately bear the burden of servicing it.<sup>2</sup> Ensuring the alignment of the interests within each pair is a fundamental problem in contract theory. The nature of the problems is similar for sovereign and private borrowing, but their solutions are fundamentally different.

The incentive problem between creditors and borrowers is straight-forward: having contracted debt, the borrower would prefer not to repay it. The creditor only lends, however, if he has a reasonable expectation to be repaid. To solve this problem, creditors of private entities can rely on the judicial system to reassign the property rights of assets from the borrower to the creditor should the borrower default. This not only reduces incentives for non-payment by borrowers, but also provides incentives for creditors to enforce their claims since the prejudicial consequences for a defaulting debtor provides them with a direct benefit. Both creditors and borrowers gain from the enforcement mechanism since it allows trade of resources to take place.

For sovereign borrowing, the solution is less simple and there is great controversy as to the practical reasons why countries comply with their contractual obligations and repay their debts.

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<sup>1</sup> A detailed discussion of the different definitions of odious debt and their reflection in law is provided in Nehru and Thomas (2008).

<sup>2</sup> Note that the creditor in the first relationship is the country, represented by the government. The creditor is therefore not one actor (government, population) acting independently, but rather the outcome of the first agency relationship: the government acting on behalf of the population.

As noted by several authors at least since Eaton and Gersovitz (1981), the transfer of property rights from a sovereign borrower to its creditors through the courts poses substantial challenges. Creditors would not be expected to obtain favorable judgments in courts of the borrowing country, and judgments obtained in foreign courts are generally enforceable only in a subset of jurisdictions and therefore be limited to assets located therein. While cross-border enforcement is possible in principle (through “gunboats,” for example), most authors agree that this is politically untenable today, and there is evidence that even well-known historical examples of “gunboat enforcement” may overstate its role (see Tomz, 2007, chapter 6). Some authors have therefore argued that sovereign borrowing needs to be self-enforcing (or enforced by the “market”) through optimal reactions by creditors that would lead, for example, to the exclusion of defaulting countries from future borrowing. A lack of coordination among creditors can, however, easily undermine self-enforcement, making it more difficult for creditors to be repaid once a sovereign creditor declares default <sup>3</sup>

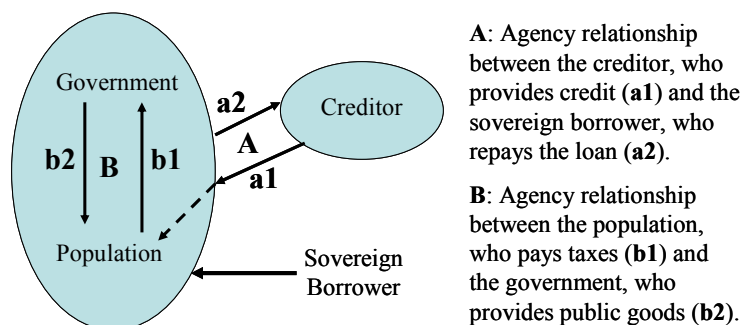
Solving the second incentive problem – between those responsible for negotiating and contracting the loans and those that bear the burden of repayment – is even more complex in the context of sovereign borrowing. The design and enforcement of anti-corruption and transparency laws (analogous to the laws that protect shareholders from management fraud) are ultimately done by the public authorities of the sovereign borrower, and not an independent party. Most importantly, outcome-contingent compensation contracts for government leaders, such as those that exist for managers of private firms, do generally not exist (for example, in no country does the president earn a bonus for exceptional economic growth).<sup>4</sup> The main form of incentives provided to government executives is the possibility that they may not be re-elected or may be overthrown.

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<sup>3</sup>Bulow and Rogoff (1989) argue that non-creditor banks would profit from selling an insurance contract to the defaulting country (using the defaulted amounts) that would remove the consumption-smoothing motive for borrowing, thus rendering market exclusion an ineffective punishment. These authors conclude that, absent market or political enforcement, only the existence of legal threats can ensure sovereign debt repayments.

<sup>4</sup> The recently instituted \$5 million prize to “well-behaved” African Presidents, funded by Sudanese telecoms entrepreneur Mo Ibrahim, could be considered as a proxy for such a concept. For further details see Reuters Foundation, “Thumbs up or down for African prize?” at [www.alertnet.org/db/blogs/22870/2006/09/27-133957-1.htm](http://www.alertnet.org/db/blogs/22870/2006/09/27-133957-1.htm)

Figure 1: Agency problems in sovereign debt



This agency problem between government executives and their population is ultimately at the heart of the debate over the cancellation of “odious” debts: definitions of “odious” debt proposed in the literature tend to have in common that the proceeds from the borrowing were not used for the benefit of the population of the country.<sup>5</sup> Proponents of the different policy approaches on odious debt argue that placing the responsibility on lenders to ensure that loans to sovereign borrowers are aligned with the interests of the population would solve this incentive problem,

The paper identifies four different policy approaches to odious debt. The *odious regimes* framework argues that no debts incurred by a regime deemed odious should be enforceable. Under an ex-post version of this framework, successor regimes can argue (through litigation) that the predecessor regime was odious – and therefore that debt contracted by the predecessor need not be honored. In practical terms this would imply that successful litigation would prevent courts from attaching assets to enforce the repayment of a debt contracted by the odious regime. Under an ex-ante version of the *odious regimes* framework, put forward by Jayachandran and Kremer (2006) and Bolton and Skeel (2007), an international body (such as the United Nations Security Council) would declare certain regimes

<sup>5</sup>The emergence of a doctrine of odious debts is generally linked to Alexander Nahum Sack (1927), who identified three categories of odious debts, namely: (a) “regime debts” (when a despotic regime “contracts a debt, not for the needs and in the interest of the state, but to strengthen its own despotic regime”); (b) “subjugation debts” (when the government “contracts debts to subjugate the population of part of its territory or to colonize it by members of the dominant nationality”); and (c) “war debts” (when the government of a state contracts debts “with a view to waging war against another state”). However, the concept of odious debt as currently used by Civil Society organizations has been expanded, including “criminal”, “ineffective” and “unfair” debts or debts “used against the interest of the population.” Regarding the application of this expanded definition, there are formidable practical difficulties in determining whether debts were contracted against the interest of the population, an issue that we do not discuss in this chapter.

odious and agree that courts in member countries would not enforce debt contracts entered with such odious regimes.

The *odious loans* framework argues that those loans that were used against the interest of the population should be cancelled or declared unenforceable. Under the ex-post version of this framework, old loans are audited, and those deemed illegitimate (regardless of the regime that contracted them) are repudiated. This would provide incentives for creditors to “enter” the second agency relationship (the dashed line in Figure 1) in order to reduce the risk of not being repaid. Under the ex-ante version of this framework creditors must undertake sufficient due diligence to certify that a loan is being used for legitimate purposes, in which case that loan could not later be deemed odious.

All proposals implicitly assume that the enforcement of sovereign borrowing takes place through the legal system – and therefore that borrowers would indeed repudiate “odious debts” if they were legally allowed to do so.<sup>6</sup> This assumes that repudiation backed legally by an odious debt framework would result in few or no costs to the borrower. While this seems plausible at first sight, the extent to which legal enforcement is effective in the context of sovereign debt is unclear. Moreover, some authors argue that the costs of market enforcement dominate those of legal enforcement. Putting the argument differently, a country could, without an odious debt framework, repudiate its debts for any reason, including on the basis that they are deemed to be odious. To be beneficial to a debtor country, and ultimately a country’s population, the proposed policy approaches must reduce existing costs of repudiation.

Therefore, in this paper we draw from the literature on sovereign debt to ask two questions that are fundamental in the “odious debt” debate: (1) what are the costs that countries would experience if they were to repudiate debts deemed in any way “odious”; and (2) how would the implementation of the above mentioned odious debt policies change these costs?

Throughout this paper we recognize that there is an important distinction between commercial creditors (including bondholders) and official creditors (both bilateral and multilateral).

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<sup>6</sup> This is largely reflected in the current debate over the existence of an “odious debt doctrine”. See, for example, Thomas and Nehru (2008). The main exception is Kremer and Jayachandran (2002), who considered the effect of an odious debt regime on market enforcement. Curiously, Jayachandran and Kremer (2006) return to legal costs as the sole enforcement mechanism.

Commercial lenders are assumed to maximize profits, whereas official creditors are motivated by non-commercial interests, such as political incentives, poverty reduction, etc., that would be expected to lead to behaviors distinct from commercial creditors.

This paper is organized as follows: in Section II, we review the enforcement mechanisms identified in the literature and the existing estimates of their relative importance; in Section III we discuss how the different proposals for an odious debt doctrine in international law could affect these costs; Section IV draws the conclusions.

## II. THE COSTS OF DEBT REPUDIATION

In this section we examine the costs that a country would face if its government decided to repudiate its debts, a subject that has been studied extensively in the economics literature. As discussed, in the previous section solving the incentive problem between creditors and borrowers is not straightforward in the context of sovereign debt. We therefore first identify and discuss broad types of enforcement mechanisms that have been proposed in the literature to ensure payment on external debt by sovereign borrowers. In the second part of this section, we discuss the empirical evidence on the magnitude and relevance of these different types of costs.

**Table 1: Costs of debt repudiation**

Enforcement /Creditor Type	<u>Official Creditors</u>	<u>Commercial Creditors</u>
Political	<ul style="list-style-type: none"> <li>- “Gunboats” (military intervention or pressure)</li> <li>- Trade sanctions</li> <li>- External control of a country’s finances</li> </ul>	
Legal	<ul style="list-style-type: none"> <li>- Restrictions on access to new financing</li> <li>- Comparability of treatment clauses</li> </ul>	<ul style="list-style-type: none"> <li>- Asset seizures</li> <li>- Cross default</li> <li>- Legal barriers to access to finance (e.g. trade credits).</li> </ul>
Market (self-enforcing mechanisms)	<ul style="list-style-type: none"> <li>- Reduced ability to lend in the long-term (resource constraints)</li> </ul>	<ul style="list-style-type: none"> <li>- Higher costs of financing</li> <li>- Limited access to new financing (e.g. trade credits)</li> <li>- Capital flight</li> <li>- Impact on domestic economy</li> </ul>

Three broad categories of sanctions have been postulated in the theoretical literature as enforcing sovereign debt contracts: political, legal and market enforcement, which are summarized in Table 1. While it seems obvious that political enforcement (“gunboat diplomacy”) could, in principle, enforce sovereign debts, there seems to be an equally strong consensus that this type of enforcement is essentially untenable politically in present times. The relevance of legal and market enforcement mechanisms is controversial in both the theoretical and empirical literature. In general, authors recognize that some legal enforcement exists, though its role is generally much less important than in the context of private borrowing. Most of the theoretical literature

that argues in favor of a prominent role for legal enforcement does so as a “residual” explanation after arguing against market enforcement.

### *1. Types of Enforcement*

**Political enforcement** refers to actions imposed by governments on creditor countries in response to a default and includes military action (also commonly known as “enforcement by gunboat”), trade or other diplomatic sanctions, as well as external control of the country’s finances (e.g., customs revenues).<sup>7</sup> Political enforcement does not require a court ruling on the default, and its main characteristic is the act of a sovereign government against another.

**Legal enforcement** refers to the costs that emerge as the result of legal proceedings, or from the activation of contractual clauses. This category includes asset seizures, the activation of contractual clauses (such as cross-default), as well as expenses incurred in the process of litigation (lawyers’ fees, the time that government officials must spend assisting in the process, etc.). It would also include consequences (such as difficulty in obtaining new financing) that arguably would not be experienced absent litigation.<sup>8</sup> Delays to restructuring defaulted debt caused by legal action or contractual obligations (e.g., unanimity clauses) may also be included as legal costs if such delay is costly to the country (e.g., if it cannot borrow while it remains formally in default). Contrary to political enforcement, legal enforcement does not necessarily take place in the sovereign borrower’s jurisdiction.<sup>9</sup> Rather, legal proceedings usually take place in the courts of the creditor countries, which implies that only those assets that are outside the borrowing country are available for seizure and attachment by the courts, save for procedures for the recognition of foreign judgments in the borrowing country.

**Market enforcement** refers to the impact of a default (or the risk of default) on the borrower’s access to new financing. As a consequence of default, the cost of new loans may be higher, or the amount of available financing may be lower. This mechanism is also frequently referred to as

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<sup>7</sup> Mitchener (2005) refers to political sanctions as “supersanctions.”

<sup>8</sup> For example, creditors tried to stop Argentina from proceeding with its debt restructuring transaction by asking the courts to seize the bonds tendered in the exchange as an Argentine asset.

<sup>9</sup> However, exceptions exist: some Latin American railroads were seized by creditors in the late 19<sup>th</sup> century.

“reputation.” For our purposes, it is useful to think of it as the contract’s self enforcement features that would emerge without any legal or political enforcement. The proposed odious debt policies, while possibly influencing legal costs, are unlikely to affect the consequences ensuing from the self-enforcing nature of sovereign debt contracts.

There are two main types of theoretical models that explain why a default leads to restrictions in a country’s access to finance. In “adverse selection” models, there are different types of government: “good payers” and “bad payers”.<sup>10</sup> A default provides a signal that the government is of the “bad payer” type, which would imply higher financing costs. Under certain “moral hazard” models, if countries are motivated to borrow to smooth consumption during bad times, a possible equilibrium of the repeated borrowing game would be for creditors to exclude defaulting countries from borrowing in the future to enforce payment (Eaton and Gersovitz, 1981).<sup>11</sup> A related model (Grossman and van Huyck, 1989) differentiates between “excusable” defaults (when the country is unable to pay due to a negative shock) and non-excusable defaults (when the country is able, but unwilling, to pay), with only the latter leading to exclusion from the credit markets.

Higher interest rates and/or limitation on new financing are expected to have economy-wide impacts. The reputation in sovereign debt repayments could affect other economic areas, such as trade or FDI, therefore generating an economy-wide negative impact of default (see, for example, Kletzer and Wright, 2002). Moreover, some reputational models suggest that a default signals a bad “type” not only with regard to sovereign debt, but also to property rights in general, which may lead to capital flight. The government’s inability to borrow externally combined with capital flight would exert pressure on the domestic economy through effects on the exchange rate

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<sup>10</sup> “Adverse selection” models were introduced by Akerlof (1970), who noted that relevant characteristics of actors are often observed only imperfectly (in this example, the willingness to repay of governments), and creditors must rely on estimates. When types are indistinguishable, the average willingness to pay is below that of “good payers”, but above that of “bad payers”. Since borrowing costs can only rely on the average, costs are too high for “good payers,” who may choose not to borrow, and too low for “bad payers.” Therefore, there will be an (adverse) self-selection of “bad payers” in the market. This situation can be partly remedied by credible signals of creditworthiness.

<sup>11</sup> “Moral hazard” models imply that the actions of actors are imperfectly observed, and would emerge, for example, when it is not possible to distinguish whether a default is a result of inability or unwillingness to repay. Because of this, there is a “temptation” by borrowers to claim inability when they are actually unwilling to repay.

and the domestic public debt. Finally, domestic financial institutions may be holders of the government debt, which could create a link between domestic banking crisis and a default on sovereign obligations.

## 2. *Enforcement by Type of Creditor*

While market enforcement applies primarily to commercial creditors, official creditors mimic some enforcement mechanisms of the market by reducing (or suspending) lending to borrowers who default to them. While a political decision could be made to remove these sanctions, we consider them a form of legal enforcement mechanisms since they are generally anchored in the creditors' statutes. For example, default to multilateral creditors generally triggers a contractual suspension of new disbursements.

Official creditors have also used litigation in the past, but mostly indirectly through the sale of claims to private creditors that then attempt to enforce them through the legal system.<sup>12</sup> Another example of contractual enforcement used by official creditors is the comparability of treatment clause found in all Paris Club debt restructuring agreements. This clause requires borrowers to seek comparable debt reduction from other bilateral creditors and also from commercial creditors. It thus serves a similar purpose as a cross-default clause in some debt contracts by preventing countries from “seeking debt reduction” on their official debt without “defaulting” to commercial creditors as well.

Finally, the overall amount of resources available to official creditors – although ultimately a political decision – is affected by default or the risk thereof. This is the closest to “market enforcement” as it applies to official creditors, since it is driven by resource constraints. Lost

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<sup>12</sup> One example is the case Donegal versus Zambia. In 1979, Romania extended a US\$15 million credit facility to Zambia for purchasing agricultural machinery. Zambia defaulted and fell into arrears in 1981. In 1999, Donegal International (a distressed debt fund) offered to buy the debt and after lengthy negotiation Romania sold the debt to Donegal for US\$3.2 million (on a claim with a face value of US\$30 million). In 2007, the English High Court ruled that Donegal could claim US\$15.4 million. More information on this case can be found in Box 5 of “International Development Association and International Monetary Fund, The Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) - Status of Implementation Report, August 2008” at <http://siteresources.worldbank.org/INTDEBTDEPT/ProgressReports/21501008/HIPCProgressReport20070828.pdf>

flows from non-payment directly reduce official creditors' resources for new lending. Moreover, high risk of default requires greater provisions by some creditors, which reduces the amounts available for new lending.

## *2. Empirical Evidence*

### *2.1 Political Enforcement*

There exists sizeable empirical evidence from economic history regarding past relevance of political enforcement, such as military intervention or foreign control of a country's economy<sup>13</sup>. Ahmed, Alfaro and Maurer (2007) show that the imposition of the "Roosevelt Corollary" – whereby, in the first quarter of last century, the United States would intervene in Latin American countries that had difficulties servicing their debts – reduced financing costs of the countries that were intervened. Mitchener (2005) estimates a probability of political enforcement in case of default in the period 1870-1913 (the gold standard era) of 25 percent. He finds that yield spreads declined by about 800 basis points and the defaulting country experienced an almost 100 percent reduction of the time in default when sovereign default was punished with political sanctions. The relationship between default and political sanctions may, however, have been spurious as Tomz (2007) points out. He notes that, prior to World War I, countries that defaulted were indeed targets of military intervention at a higher rate than countries that serviced their debts. But he argues that the political sanctions were more likely for defaulters since they were often already involved in other disputes. As an example, he argues that the military intervention in Venezuela in 1902 – one of the most prominent examples of "gunboat" enforcement – was not due to the default on its foreign bonds, but rather due to other acts against British and German interests. Specifically, although the Venezuelan government defaulted in 1901 on bonds held by British and German investors, Venezuela had been in default four times between 1847 and 1901, without any intervention by the British military. Tomz argues, based on an analysis of historical

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<sup>13</sup>An example is the case of the Egyptian default at the end of the 19<sup>th</sup> century. A costly war with Ethiopia and lavish government spending led Egypt's debt to climb fourteen-fold over a thirteen-year period and in 1876 the country was essentially "bankrupt." Ismail, the Khedive of Egypt, declared a unilateral partial default on the outstanding bonds. In response, the British and the French governments demanded to intervene in the country's finances, and pressured the Ottoman Sultan to depose Ismail and replace him with his son, Tewfik. Egypt ended up losing its national sovereignty. British and French officials took control of government revenue, managing it in the interests of the private creditors. For further details see Chowdhry (1991)..

documents, that the real motivation for the intervention in 1902 was multiple attacks by the Venezuelan navy on British vessels in the Caribbean.

Notwithstanding strong evidence that trade volumes are lower following default (see discussion below), there is little evidence that government-imposed, *overt* trade sanctions have been used to enforce sovereign debt contracts – at least in the past 30 years. Martinez and Sandleris (2006) report that they could not find a single instance of substantial and overt trade sanctions in 116 sovereign defaults with private creditors and 269 with official creditors over the past 30 years.

Regardless of whether political enforcement was ever effective, it is incompatible with existing international law, and there does seem to be a consensus against the utilization of such types of intervention.

## 2.2 Legal Enforcement

An extensive literature has analyzed the legal mechanisms available to creditors and debtors in the context of sovereign debt.<sup>14</sup> A key principle discussed in this literature is that of sovereign immunity, even though such laws as the US's Foreign Sovereign Immunities Act of 1976 or the UK's State Immunity Act of 1978 have stripped sovereign immunity related to commercial transactions. Following a bellwether US Supreme Court decision in *Republic of Argentina et al. v. Weltover*, which upheld that sovereign debt constituted a non-protected activity under the US Sovereign Immunities Act, a number of other lawsuits have been brought forward against defaulting sovereign borrowers with a mixed record of success. As noted by Sturzenegger and Zettelmeyer (2007), both creditors and borrowers have honed their legal tactics, the former to expand their abilities to seize assets, and the latter to avoid seizures.

A related literature on sovereign bankruptcy has analyzed the optimality of existing contractual characteristics of sovereign debt and the need for a sovereign debt restructuring mechanism.<sup>15</sup>

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<sup>14</sup> See, for example, Waibel (2003) and Sturzenegger and Zettelmeyer (2007).

<sup>15</sup> See, for example, Rogoff and Zettelmeyer (2002) and Bolton and Jeanne (2007).

This literature focuses in particular on the tension between the ex-post and ex-ante efficiency of certain aspects of sovereign bond contracts. Clauses that make debt restructuring difficult (for example, those that require the unanimity of holders to modify the repayment terms of the contract) make default more costly and therefore, ex-ante, reduce the risk premium that borrowers must pay. However, once a default occurs, such clauses are inefficient. Ex-post, both the defaulting borrower and a majority of creditors would prefer that restructuring were easier due to the dead-weight losses associated with a protracted restructuring. This literature is mostly theoretical, however, simply acknowledging that delays in reaching an agreement were costly in a broad sense, usually measured in the aggregate using changes to GDP.

Empirical evidence on the average or aggregate importance of legal costs in enforcing sovereign debt contracts, as well as estimates of their magnitude, has been limited. Evidence exists from case studies, however, that the ability of creditors to ultimately obtain payments or asset transfers from sovereign borrowers – what may be called “direct legal sanctions” – appears to have been limited. Creditors have been able to obtain judgments in a number of cases, but have found it difficult to collect on them (see Box 1 below for one example). This difficulty is reflected in the fact that only a minority of creditors (so-called “distressed asset” funds) is usually involved in lawsuits. Consider for example the recent default by Argentina in 2001. Despite unusually harsh terms for creditors (namely a reduction in the present value of the obligations in the order of 70 percent), over 75 percent of creditors accepted the restructuring offered by the government in 2005 instead of engaging in lawsuits. This reflects the expectation by most investors that the potential for recovery through legal means was limited.

Estimates of actual litigation costs, those expenses that governments must incur on lawyers’ and court fees, as well as the opportunity cost of government officials that work on the litigation are rarely discussed in the literature. Although those costs may be trivial in most cases (especially relative to the costs of asset seizure), they can be significant for small economies and large relative to the original claim amount, as shown in Box 1.

**Box 1: Noga vs. Russia (updated from M. Wright, 2002)**

Noga, a Swiss company, entered into a contract with Russia to exchange oil for certain products that it agreed to export. Russia explicitly waived its right to sovereign immunity under the contract. In 1993, Russia repudiated the contract and offered to settle it under London Club terms (i.e., with a discount on the amount of claims outstanding). Noga sued, and obtained judgments in Luxembourg and Switzerland to freeze Russian government bank accounts with US\$700 million, which led Russia to establish a shell company to hold its offshore assets. In 1996, the Luxembourg accounts were unfrozen, without a payment being made to Noga. In 1997, a Swedish arbitration court awarded Noga US\$63 million, compared to US\$ 800 million sought. Russia refused to pay and the lawsuits continued.

The year 2000 saw a number of lawsuits in different jurisdictions. A French court ordered the seizure of bank accounts of some 70 Russian entities that were connected with the state, including the Russian embassy in Paris and its UNESCO delegation. Within a few months of the award, a judge dismissed the case and ordered Noga to pay damages to Russia. A French presidential decree was required to prevent the seizure of Russian President Vladimir Putin's personal aircraft at Orly airport, and Noga obtained a judgment to impound a Russian ship in the French port of Brest, but again the suit was later dismissed and Noga was ordered to pay damages. Noga also lost a suit filed in the United States requesting the seizure of uranium that was allegedly owned by Russia.

In June, 2001, Noga attempted to seize Russian fighter jets at Le Bourget air show. The planes were scrambled ahead of the bailiffs, after the Russian contingent were warned by the festival organizers, who also helped drag the planes to the end of the runaway, gave permission for an emergency takeoff and opened an air corridor.

The case continued in Swiss courts, which ruled again in favor of Noga in 2002. In 2005, 54 paintings from the Pushkin Museum of Fine Arts, insured at a value of US\$ 1 billion, were seized on their way back from Switzerland to Russia. The Swiss government intervened, and the paintings returned to Russia. In 2006, a Russian-born US investor appears to have bought the debt from Noga, although it is not yet clear whether Noga no longer has any claims against the Russian government.

By March 2006, Noga stated it had spent US\$ 40 million in legal expenses over the years, and it estimated that Russia spent twice as much. As of May 2008, the Russian government had plans to sue Noga for damages under previous seizure orders.

Recognizing that recent cases of sovereign default were very costly for both debtor countries and creditors, the IMF proposed in 2001 the creation of a sovereign debt restructuring mechanism (SDRM) to deal with unsustainable debt burdens of emerging market countries. The proposal consisted, in particular, of establishing a universal legal framework to facilitate negotiations and to empower creditors to approve a debt restructuring agreement with a debtor country that would bind in minority dissenting creditors. The agreement could precede or follow an event or default. At the same time, the IMF also considered a complementary approach, in which debt restructurings could be facilitated by enhanced use of certain contractual provisions in sovereign debt contracts.<sup>16</sup>

Even if expected direct legal costs of defaulting may be limited, there is evidence that the threat of litigation alone acts to restrict, at least in the short term, the access of countries to certain types of financing. This applies particularly to trade financing, which relies on short-term credits and letters of credit. Alexander (1987) notes that countries find it difficult to obtain letters of credit during default – since creditors may fear that repayments on these new credit lines could be seized, even if temporarily, by litigating creditors. This fear forces countries to conduct roundabout transactions, which Alexander claims in one case to have been estimated at between 10 and 15 percent the value of trade. Similarly, it is possible that all types of borrowing are restricted by the risk of seizures. Consistent with this hypothesis, there are very few exceptions of countries that issue new debt before reaching a restructuring agreement with their creditors. Tomz (2007) reports that, between 1820 and 1870, only a single loan was issued by a country that was in default and had not yet restructured its obligations.

The line between these (indirect) legal costs and market enforcement (discussed below) is rather blurry: it is possible that creditors would re-establish credit more quickly absent legal threats, whereas they could also find alternative coordination devices to punish defaulting countries even absent the threat of litigation. While we are not aware of a study that attempts to separate these two channels, Ahmed, Alfaro and Maurer (2007) provide some insight by testing empirically the comparative effectiveness of political and legal enforcement. Ahmed et al. compare the behavior of borrowing costs following two important events: (i) the announcement of the “Roosevelt

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<sup>16</sup> More information on the SDRM can be found at <http://www.imf.org/external/np/exr/facts/sdrm.htm>

Corollary,” considered by most authors to be a period where political sanctions were widely used to enforce sovereign debt, and (ii) the landmark 1996 decision of *Pravin v. Peru*, which signaled to investors that courts could be used to force payments from creditors. The authors find evidence that political enforcement (given by the Roosevelt Corollary) reduced borrowing costs, whereas the impact of legal sanctions was “weak at best” (Ahmed et al. 2007, p. 26). Nevertheless, because the data used to test the legal enforcement hypothesis begins *after* what is probably a more important landmark from the point of view of investor expectations – namely the above-mentioned 1992 US Supreme Court decision on *Republic of Argentina et al. v. Weltover* – their conclusions must be taken with caution.

The literature is silent on actual estimates of the costs arising from legal enforcement by official creditors. Nevertheless, the recent case of the Argentina default is illustrative. Argentina defaulted on its Paris Club debt in 2002. Since then, many of the government-controlled insurance agencies, export-import banks and other institutions linked to Paris Club members have been prevented from extending insurance or loan guarantees for projects in Argentina due to its default to the Paris Club. In the absence of such guarantees or insurance, many investors shy away from riskier projects. For example, in 2007, the first \$1.1 billion phase of a \$3.3 billion infrastructure project to extend passenger rail service in the greater Buenos Aires met with little interest from investors. As the economic recovery was tempered by capacity constraints, the cost of these sanctions has become more relevant, and Argentina in September 2008 indicated that it planned to use US\$6.7 billion of its international reserves to clear its arrears to the Paris Club, thus re-opening short-term trade credits and insurance and guarantees for investment projects financed by companies from Paris Club member countries. However, as the 2008 global financial crisis brought liquidity constraints to the fore, the plan was postponed.

This case study is suggestive of the mechanism that may lie behind the results of Rose (2005). Rose considers defaults to official creditors and finds that bilateral trade (between creditor and borrower) declines by 8 percent per year following a default and last 15 years. Rose and Spiegel (2002) use instrumental variables techniques and find a significant positive effect of bilateral trade on bilateral lending patterns: an increase of 1 percent in bilateral trade increases bilateral lending by 0.40 percent. These results must be taken with some caution, however, as defaults to

official and commercial creditors are correlated. Moreover, as discussed below, some authors question whether there is a fall in bilateral trade or just a fall in overall trade, which may be correlated with the cause of the default (a negative shock) and simply persist beyond the default.

Despite the relative shortage of empirical evidence on the costs of legal enforcement, it is likely that they are not trivial, especially indirect costs related to the effect of legal threats on a country's ability to enter into short-term credit agreements and the statutory suspension of credit from official credit agencies that provide trade credit, insurance and guarantees. Direct legal costs have been important in specific cases – consider for example the case of *Elliot Associates v. Banco de la Nacion*, where Peru was forced to settle with Elliot to avoid defaulting on all creditors of its “Brady” bonds for purely legal reasons. The available evidence for the *overall* impact of this (and similar) cases, however, appears very weak, as reported by Ahmed et al. (2007) and supported by the small fraction of creditors that rejected Argentina's restructuring offer.

### *2.3 Market (self-) Enforcement*

The economics literature has investigated extensively the empirical relevance of market enforcement of sovereign debt contracts. The type of self-enforcing sanction most commonly predicted by the theoretical literature – higher borrowing costs and/or difficulty in accessing credit – has been directly studied by a number of authors. They find some evidence that defaulting countries face, in the short term, higher financing costs and difficulty in accessing credit; however, beyond a relatively short period following the resolution of the default the effects are muted at best. A different strand of the literature looks at the effects of sovereign defaults on the aggregate economy, which is likely to be influenced (if not caused) by the market reaction to the default. These aggregate effects include impacts on GDP and trade. While defaults are clearly correlated with drops in GDP and trade, the causation mechanisms are unclear.

The literature overall has found a positive but small impact of default on the long-term cost of borrowing. Lindert and Morton (1987) find that defaults in the nineteenth century and the 1930s

did not imply higher borrowing costs in the 1970s – thus long-term effects appear negligible. De Paoli, Hoggarth and Saporta (2006) find that, for a given debt-to-GDP ratio, past defaulters pay generally higher interest rates. For example, the three non-defaulters in their sample faced lower spreads in the 2003-2005 period than ten out of the 12 defaulters – despite the fact that in most cases the defaulters had lower debt burdens in the same period. Flandreau and Zummer (2004) find that in the 1880-1914 period interest rates jump by 500 basis points immediately following a default, then by 90 basis points in the year following the end of the default episode, and 45 basis points 10 years after the default. Özler (1993) considers the impact of defaults between 1820 and 1930 and in the post-World War II period on loans extended over the 1968-1981 period. He finds that defaults prior to the 1930s do not have any impact on credit terms. The impact of a default in the 1930s is estimated at 20 basis points, while the impact of post-war IMF stand-by arrangements is estimated at 30 basis points. Borensztein and Panizza (2006a) also find that the effect of default on spreads is short-lived.

The evidence on access to new financing is similar: defaulting countries eventually recover market access, but they have problems accessing the markets before the default is resolved and immediately after the default. As mentioned earlier, Tomz (2007) finds that only one country issued debt between 1820 and 1870 while it was still in default. Eichengreen (1987) finds no relationship between default in the 1930s and borrowing after 1945. Gelos, Sahay and Sandleris (2004) find that the median number of years that countries are excluded from the markets following a default fell from four in the 1980s to zero in the 1990s. The IADB (2007) notes that, from the 1930s to the 1960s, all Latin American countries were largely excluded from the world capital markets regardless of whether they had defaulted in the 1930s; on the other hand, the lending boom of the 1990s did not exclude countries that defaulted in the 1980s.

An interesting paper by English (1996) on the external borrowings of US states in the early 1840s corroborates the evidence that market enforcement plays a role. The foreign debt of US states prior to the Civil War was not guaranteed by a federal government. Given the status of the US states, neither political nor legal enforcement was possible at that time. In the period of the early 1840s, most US states never defaulted, some were temporarily in default or partially repudiated their debts, and yet others repudiated their debts entirely. All states that did not

default were able to borrow again in the 1840s and 1850s, and all but 3 had more debt in 1860 than in 1841. The states that repudiated all their debt (Florida and Mississippi) did not issue new bonds. The situation of those states that partially defaulted was somewhere in between, and yields on their bonds remained elevated for several years.

Of course, costs of market enforcement may be different for different types of government. According to Tomz, creditors assess a country's "type" based on (i) whether the same type of government is still in power; and (ii) whether that government has defaulted or repaid at a time when the opposite would be expected (e.g., a repayment during a recession or a default during a boom). Tomz (1998) notes that most defaults during the trough of the great depression were fully expected, and therefore could not have affected the reputation of the borrowers. This would explain why the effects on later borrowing costs were muted. On the other hand, the markets rewarded countries that were expected to default but didn't: in the 1930s, prices on Argentine bonds reflected a 50 – 70 percent probability of default. As a consequence of not defaulting in difficult times, Argentina was one of the only countries that issued debt in New York and London during the depression. Özler (1993) notes that countries that had recently acquired sovereignty in the 1960s and 1970s faced borrowing costs that were as high as those countries that defaulted in earlier decades (i.e. they had not yet formed a reputation), whereas English (1996) writes that the US states that had repudiated their debt in the early 1840s were only able to borrow again after Northern-backed governments were installed.<sup>17</sup>

A default is often associated with a decline in trade. One possible channel, discussed in the previous section, is the shortage of short-term trade credits. The decline in trade would thus be the consequence of default. Another possibility would be that trade falls in line with the overall economy, and is thus related to the *cause* rather than the consequence of a default. The papers by Rose (2005) and Rose and Spiegel (2002) discussed above support the hypothesis that – regardless of the cause – trade declines follow rather than cause defaults. Similarly, Borenztein and Panizza (2006b) find that, for each year in which the sovereign is in default, an industry in the 75<sup>th</sup> percentile of the non-exporter/exporter continuum would see its growth drop by 1.7 percentage points relative to the 25<sup>th</sup> percentile. This effect only lasts as long as the country is in

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<sup>17</sup> See also Chapter 3 of Tomz (2007).

default, and only holds when considering defaults on bank loans (but not bonds). Alexander (1987) and Cline (1987) provide anecdotal evidence that Bolivia and Peru suffered severe reduction in their access to short-term trade credits as a consequence of their “confrontational” approach. On the other hand, Martinez and Sandleris (2006) argue that the declines observed by Rose (2005) are actually declines in *overall* trade – once this trend is taken into account, no significant effect on bilateral trade is found. Similarly, Tomz (2007) argues that between the two world wars governments did not service their debts in proportion to their trade with creditors, which would be expected if the reduction in trade were a result of default.

Many authors have attempted to measure the overall correlation between GDP growth and sovereign default. A commonly-cited estimate puts default “costs” at 2 percent of GDP growth (Sturzenegger, 2002).<sup>18</sup> De Paoli, Hoggarth and Saporta (2006) report much higher output losses – in the order of 7 percent per year for their median country. These measures are not very informative for our purposes, since the mechanisms through which GDP growth falls are even less well-specified than those in the case of trade. Moreover, there is substantial evidence that countries default in bad times, when their GDP growth is trending downward, thus making it difficult to distinguish between a sanction in anticipation of default and the cause of the default itself. Tomz and Mitchener (2006) find that output is 1.4 percent below trend during periods of default compared to 0.2 percent above trend when the borrower is in good standing, while Levy-Yeyati and Panizza (2006) find that, when the frequency of the data is changed from yearly to quarterly, growth rates in the post-default period are never significantly lower than in normal times. On the other hand, recessions are a significant 3 percent deeper during default episodes.

Some authors (De Paoli, Hoggarth and Saporta 2006) relate the growth costs to the fact that sovereign defaults are connected to currency and banking crisis.<sup>19</sup> Often the domestic financial sector holds government debt (including external debt, as was the case in Argentina), or its own financing would be affected through the sovereign “ceiling,” namely the risk that governments may impose restrictions on the exit of foreign exchange during an episode of default. However, it is very difficult to disentangle whether a banking and/or currency crisis are contemporary to a

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<sup>18</sup> The cost is measured as the difference between observed GDP growth and trend GDP growth.

<sup>19</sup> See Laeven and Valencia (2008) for an updated survey of episodes of banking, currency and sovereign debt crises.

debt default or whether they follow one. Given the evidence that countries generally default in bad times, it is best to consider the “output costs” of default with appropriate caution.

The discussion on market enforcement focuses exclusively on commercial creditors. Nevertheless, debt write-offs do impact resource constraints of official creditors. For example, the expected debt relief to be provided under the Highly Indebted Poor Country (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) as of 2008 by bilateral and multilateral creditors is estimated at US\$95 billion in NPV terms.<sup>20</sup>

Therefore, there is evidence that defaults affect a country’s ability, especially in the short-term, to obtain credit, which impacts trade patterns of the defaulting country. The impact of these costs appears to be short-lived but, given the severity of the recessions that lead to default (or, alternatively, the effort that some countries appear to exert to avoid default), they must be sufficiently large. The degree of pain of the default serves as a signal that the default was a matter of ability rather than willingness to pay, thus, if one accepts Tomz’s reputational theory, not affecting the ability of the country to re-gain access to markets.

#### *2.4 Summary of Costs of Repudiation*

Although political sanctions are unlikely to be imposed nowadays should a sovereign government repudiate its debts, there appears to be sufficient evidence that legal and market costs, especially through their effect on trade, may be large. While there is limited evidence for the relevance of direct legal costs or permanent increases in the cost of financing, credit constraints seem to emerge in the short-term as a consequence of market enforcement, the threat of litigation, and statutory constraints by official agencies.

As we noted in our discussion, it is difficult to separate the short-term impact on access to finance that emerges from legal or market enforcement – indeed, it is very plausible that the legal system acts as a coordination device for creditors. While legal costs cannot be ignored, the balance of the evidence does not favor the view that they dominate. Consider that several studies

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<sup>20</sup> See International Development Association and International Monetary Fund (2008).

(Özler 1993, Rose 2005) find effects that last well beyond the immediate aftermath of the default, thus well beyond the length of legal proceedings or suspensions due to default. English (1996) plausibly argues that lenders to US states in the 1840s imposed market access restriction without any apparent ability to obtain legal enforcement. The evidence in Alfaro et al. (2006), while not decisive, also suggests that legal enforcement alone is not comparable to political sanctions – begging the question of what has taken the place of the latter since it is no longer available. Finally, the small number of creditors pursuing legal remedies in a given default, and the many commercial banks that chose to delay declaring a default (and utilizing the legal system) in the 1980s also points to an important, if not dominant, role for market rather than legal enforcement.

Notwithstanding the empirical difficulty in separating legal and economic sanctions, in the next part of our analysis, we continue to impose the abstract separation between legal and market costs. It is only the latter costs that can be expected to be reduced by the proposed “odious debt” policies, as recognized by Jayachandran and Kremer (2002).

Although the existing literature does not provide estimates of magnitude of the legal and “market” costs imposed by official creditors, the practical implications of default to those creditors are more clear-cut. Countries in default to the Paris Club are unable to access official export credits and related agencies from other Paris Club creditors, unless a restructuring agreement is reached. Moreover, default to multilateral creditors triggers a contractual suspension of new disbursements from those creditors. The impact of defaults on the ability of official creditors to provide development finance has not been studied in detail but, as discussed above, in the absence of compensating transfers from donors, a higher number of defaults would limit the long-term ability of official creditors to maintain their lending levels.

### III. POTENTIAL IMPACT OF IMPLEMENTING ODIIOUS DEBT POLICY PROPOSALS

In the previous section we argued that the costs to a country that decides to repudiate its debt are only partly determined by the legal actions available to creditors. In the case of debts to commercial creditors, some (and likely most) of the costs that would emerge in case of such a repudiation would arise from market enforcement. In the case of debts to official creditors, most of the costs are indeed likely to be linked to legal action – although not in the sense of international commercial law, where the odious debt policy proposals have been largely explored, but rather as a result of the application of the statutes of these official creditors.

In this section we consider the impact of the implementation of different “odious debt” policy proposals on the costs identified in Section II above. We divide these proposals into proposals concerned with all borrowing done by specific regimes, which we term “odious regimes” framework (Bolton and Skeel, 2007) and those that are concerned with the legitimacy of specific loans: “odious loans” framework. For each of the two types we consider separately the impact of an ex-ante and an ex-post version of the proposal, and on official and commercial creditors. In all cases, we ask how the proposed policy would alter the costs of repudiating “odious” loans compared to the existing costs of repudiation.

Under an “**odious regimes**” framework (see Table 2), all the debts contracted by a regime deemed odious should not be enforceable. Under an ex-post version of this framework, successor regimes can argue (through litigation) that the predecessor regime was odious – and therefore that debt contracted by them need not be honored. In practical terms this would imply that successful litigation would prevent creditors from attaching assets to enforce the repudiation of a debt contracted by the odious regime. Under an ex-ante version of the odious regimes framework an international body would declare certain regimes odious and invite national courts not to enforce debt contracts entered with such odious regimes (or, as a variant, the UN Security Council, acting under its peace and security powers, would adopt legally binding decisions to that effect).

Under an “**odious loans**” framework, those loans that were used against the interest of the population should be cancelled or declared unenforceable. Under the ex-post version of this framework, previously contracted loans are audited and those deemed “odious” are challenged in the courts, which may not enforce obligations it finds illegitimate. Under the ex-ante version of this framework (which is more closely related to “responsible lending” rather than the different odious debt policy proposals put forward by CSOs), creditors must undertake sufficient due-diligence to certify that a loan is being used for legitimate purposes, with the expectation that such a loan would not later be deemed odious.

**Table 2: Odious Debt Frameworks**

<b>Frameworks</b>	<b>Ex-ante</b>	<b>Ex-post</b>
<b>By regime</b>	An international body would be charged with declaring regimes odious. Loans to regimes so declared would not be enforceable.	Successor regimes argue, through litigation, that the predecessor regime was odious and therefore that its debts should not be honored.
<b>Loan-by-loan</b>	Loans certified to comply with the framework’s standards are enforceable, while those that do not may not be.	Disbursed loans are audited and borrowers sue for cancellation of those loans found to be odious.

Before we proceed with a systematic analysis of the impact of these different policies on the costs identified earlier, we must consider whether any odious debt policies may create new costs. If regimes are barred from borrowing – or costs of financing increase – due to the implementation of an odious debt framework, at least three new costs could plausibly emerge: (i) “odious” regimes may default on debt, previously contracted by non-odious regimes, leaving successor governments with a large stock of arrears on debt that is according to the policy proposal legitimate and must therefore be repaid; (ii) the consumption/investment choice of an odious regime may be distorted against the interests of the population (Choi and Posner, 2005; Gil Sander, 2008); and (iii) odious regimes may substitute borrowing with more intensive exploitation of non-renewable natural resources (Choi and Posner, 2005), a topic discussed in

greater detail by Ochoa (2008), who concludes that “alternative sources [of financing for odious regimes] may often result in more long-term damage to the people and the territory of a country than debt.” (Ochoa 2008, p. 159).

## *1. Odious Regimes*

### *1.1 Ex-post version*

We assume that an ex-post odious regime framework would allow a government to argue in front of an appropriate forum (e.g., the International Court of Justice or another relevant court or arbitral tribunal entrusted with the settlement of disputes between the parties to the loan agreement in question) that its predecessor regime was odious, and therefore that *all* loans made to the regime cannot be enforced or should not trigger the usual default provision in commercial contracts or official debt agreements.

Under the ex-post version of the odious regimes framework, the change in legal costs related to **commercial debt** are ambiguous, though likely similar to the situation without the framework. Successor governments would have to argue the case that their predecessors were odious. Given the time required to establish the odious nature of the previous regime through litigation, the ex-post framework would probably not improve access to financing that would be restricted by legal means (i.e. there may still be a shortage of short-term credits due to fear of attachment, which may still lead to a reduction in trade). The actual costs of engaging in litigation would still have to be undertaken. Successful litigation would allow work-out at favorable terms, although it is difficult to estimate the magnitude of such improvement in terms. For example, Argentina received a reduction of over 70 percent of the nominal amount of its debt from commercial creditors without an odious debt framework in place. Nevertheless, the legal costs are likely to be lower when compared to a loan-by-loan approach, since a decision to declare a regime odious would presumably cover all the debts contracted by it.

If the ex-post odious regimes framework does achieve a reduction in the costs of repudiating odious debts, the costs of borrowing for all countries are likely to increase, since creditors would price in an expected probability of the regime being declared odious (and thus having a higher

probability of defaulting). This increase in borrowing costs would be higher for those regimes/loans that are most likely to be odious; indeed, there are likely to be cases where new lending dries up altogether due to the high risk of a repudiation. However, in many cases there will be uncertainty about the regime type, and legitimate regimes, i.e. regimes that are never declared odious, would suffer from higher borrowing costs.

Since the willingness of creditors to offer new loans is an important incentive for debt repayment, if the ex-post odious regime framework succeeds in restricting access of odious regimes to new loans, those regimes may be more likely to default on earlier (and by definition legitimate) debt. Moreover, there may be an adverse selection effect: those creditors that are most committed to the framework (and do not extend loans to potentially odious regimes) will be punished with defaults on loans contracted by predecessor regimes, whereas “rogue” creditors that lend to “odious” regimes are likely to be repaid (at least as long as the odious regime is in power). Thus, even if the framework punishes the “rogue” creditors once the odious regime is overthrown, the successor regime may have to deal with large amounts of arrears on legitimate debt, often incurring substantial penalties in addition to interest on overdue principal and being cut-off from lending till arrears are cleared.

The legal costs related to **official debt** under the ex-post odious regimes framework are also ambiguous. Lending by many official creditors is related to a country’s quality of policies and institutions and tends in any case to dry out in response to concern from civil society in donor countries in countries with severe policy failures. To the extent that the framework institutionalizes the restriction of lending to odious regimes, there will be less “odious debt” to be worked out. But, similarly to commercial debt, incentives for odious regimes to default on legitimate debt would be created. Official creditors generally do not lend into arrears, and it is unlikely that the framework, with its requirement of a litigation process to argue that a regime is “odious,” would speed up a debt work-out relative to the existing restructuring mechanisms. Thus, the effects of restrictions on short-term credits would likely remain unchanged from the current situation. Since official creditors will also be unable to predict perfectly which regimes would be deemed ex-post odious, in the long run the availability of resources could be decreased overall given a fixed lending envelope and fixed borrowing costs.

### Summary

The ex-post odious regimes framework is likely to reduce the welfare of countries that have legitimate regimes, since they are likely to face higher borrowing costs due to the risk of being declared odious ex-post. The welfare impact on countries under odious regimes is ambiguous, but likely to be negative: legal costs are unlikely to be reduced, and any benefits from reduced lending to odious regimes are likely to be offset by the cost of dealing with costly legitimate arrears left by the previous odious regime.

**Table 3: Ex-post Odious Regime – Summary**

Creditor/Cost	Legal	Market
Commercial	Ambiguous/similar – litigation costs must still be incurred.	Possibly lower difference between pre- and post-repudiation borrowing costs, mostly due to higher pre-default costs for all borrowers.
Official	Ambiguous/similar – need for litigation and arrears on legitimate debt will require time for work-out.	Higher –potentially more arrears to creditors that stop lending to previous regime.

### 1.2 Ex-ante framework

We consider an ex-ante odious regime framework in the vein of that suggested by Jayachandran and Kremer (2006), whereby an appropriate institution (e.g., the UN Security Council or the IMF) would declare a regime odious based on human rights or financial mismanagement, with the consequence that *all* loans made to it *from that point on* would not be enforceable or that the usual default provision in commercial or official debt contracts would not be triggered. The key feature of the ex-ante version of the odious regime framework is that the debt of the odious regime would be legitimate until the appropriate institution declares it odious – otherwise, the same analysis of the ex-post version applies. As argued by Jayachandran and Kremer, this would preserve legitimate lending by ensuring creditors that they would only be “punished” if they knowingly lent to a regime that acts against the interest of its population, where the “knowingly” would be precisely defined by the declaration.

Under the ex-ante version of the odious regimes framework, the legal costs related to repudiating **commercial debt** contracted by the odious regime are likely to decline. Indirect legal costs – such as the potential difficulty in obtaining letters of credit and other short-term trade financing – are also likely to decline since there would be no delay in establishing the illegitimacy of “odious” loans. However, there will be legal costs associated with the work-out of arrears on legitimate debt, which the new regime would be expected to inherit from the predecessor odious regime as argued earlier. Since by definition these would be arrears on legitimate debt, the terms of the work-out are unlikely to be at more favorable terms than would be available without the policy in place.

The market costs related to repudiating commercial debt contracted by the odious regime are likely to decline, in part due to an increase in borrowing costs pre-default. The increase in borrowing costs will depend on the probability that existing regimes will be declared odious, as well as the probability that odious regimes will be replaced by non-odious regimes. An open question is whether markets would consider repudiation in those circumstances “justifiable” and would coordinate not to “punish” the country. As shown by Kremer and Jayachandran (2002), this is one possible equilibrium, but there are others where restrictions to finance could emerge.<sup>21</sup>

Since odious regimes are likely to accumulate arrears on legitimate debt (at least to some creditors), restrictions in the availability and cost of financing for non-odious regimes is likely proportional to the probability that regimes would be declared odious. Thus, some of the same concerns as with the ex-post regime still arise.

Under the ex-ante version of the odious regime framework, the legal costs related to repudiating **official debt** contracted by the odious regime are ambiguous. While lending to “odious” regimes would decrease and hence, the amount of debt “odious” regimes could default on, the incentive to default on legitimate debt would increase for these regimes. As with the ex-post framework, odious regimes would have incentives to default on legitimate debts, leading to costs associated

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<sup>21</sup> The questions arise whether markets would perceive the successor to an odious regime that defaults on “odious” debt as a “bad” payer and whether markets will punish successor governments because they cannot coordinate around the declaration of odiousness (as discussed in Kremer and Jayachandran (2002)).

with the clearance of arrears on debt contracted by a non-odious government, which are unlikely to be lower than existing costs for restructuring official debt.

### *Summary*

The ex-ante odious regime policy proposal has some clear advantages over the ex-post proposal by clearly identifying which loans are enforceable. In both cases, the benefits may be limited by higher borrowing costs for all regimes that would result if borrowing restrictions make odious regimes more likely to default on non-odious debt. Moreover, there are likely to exist tremendous practical difficulties of achieving consensus within any international to identify odious debts. The behavior of official creditors is unlikely to change drastically, since many already in effect refuse to lend to certain regimes, and those that do generally do not expect to enforce their claims in Western courts and may only be deterred by the inability to sell their claims, a practice that is relatively uncommon.

**Table 4: Ex-ante Odious Regime – Summary of Costs**

Creditor/Cost	Legal	Market
Commercial	Ambiguous. Lower through drying up of lending to the regime ex-ante, but legitimate debt in default could receive less favorable treatment.	Ambiguous. If the market coordinates around the declaration of odiousness as a justifiable default, costs could decline. Overall costs likely to increase to all borrowers.
Official	Decline in magnitude of lending may be small, since some creditors already restrict lending to certain regimes.	Higher, because more legitimate arrears could accumulate as fewer creditors lend to the odious regime.

## *2. Odious Loans*

### *2.1 Ex-post framework*

The ex-post odious loan proposal suggest that countries should have audits of their debt portfolios and repudiate those loans that have been deemed odious, regardless of the type of

regime that contracted the debt.<sup>22</sup> Governments would argue in front of an appropriate forum (e.g. a court or arbitral tribunal entrusted with settling disputes between the parties) that, based on the results of its audit, the loan is odious and the court or arbitral tribunal should therefore not pronounce on its repayment.

Legal costs related to repudiating “odious” **commercial debt** under the ex-post odious loans framework are likely to be higher than those associated with current defaults. Direct legal costs would increase since costly and time-consuming debt audits would be required in addition to the costly litigation required to argue that the loans are odious. Moreover, indirect legal costs are unlikely to be changed. Given the lag to establish the odious nature of the debt in legal proceedings, this version of the framework would probably not improve access to financing, restricted by legal means. Finally, successful litigation will likely allow for full cancellation of the claim, which is more than what may be obtained without the framework.

Market costs related to repudiating commercial debt under the ex-post odious loan framework will depend on whether the probability of default would increase and/or whether the recovery value would decrease. As noted earlier, it is possible that legal costs under this framework increase, and therefore the probability of default would be unchanged.<sup>23</sup> However, since the expected recovery in case of a default could be reduced, creditors may compensate by increasing borrowing costs. This would also be the case if creditors incur more due-diligence expenses. Therefore, market costs would be either similar or higher than in the situation without the framework, and borrowing costs could increase for all countries. Although odious regimes are likely to find it more costly to obtain loans, it is likely that the incentives for the odious regimes to default on legitimate debt – especially from commercial creditors – will be less under the loan-by-loan approach compared to the regime-by-regime one. Thus, while it is still possible that odious regimes may have higher incentives to default on legitimate debt, this effect would likely be less severe.

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<sup>22</sup> The audit of the Ecuadorian “Comision para la Auditoria Integral de la Deuda Publica”(CAIC), established in 2007 to investigate Ecuadorian loans contracted in the period 1976 to 2006, is an example of this ex-post loan framework.

<sup>23</sup> If legal costs of debt odious are higher than those related to default because of inability to pay, countries will opt out of the framework and claim inability to pay.

Legal costs related to repudiating **official debt** under the ex-post odious loan framework would most likely increase. Direct legal costs such as litigation would be higher than under the odious regime case given the need for a costly and time-consuming debt audit. Given that official creditors may also be expected to undertake additional efforts of due-diligence of new loans (as many already do), the repudiation of any loan found ex-post to be odious would involve short-term indirect legal costs.<sup>24</sup>

Another source of the increase in costs is the high degree of subjectivity of certain definitions of odious debt. As discussed in more detail by Nehru and Thomas (2008), categories such as “ineffective” debt are often difficult to define and to identify in practical terms. It would be very difficult to differentiate between a good ex-ante project (i.e. one with high expected returns) that happened to fail (which would be well aligned with the interests of the population and therefore desirable) compared to a project that failed because it was bad ex-ante. In particular, broad definitions of odious debt would either drive up the existing due-diligence costs, or, more likely, lead to a possible “market” effect in official lending away from risky projects, which would be a welfare-reducing outcome (since this would imply that many projects that could turn out to realize high returns would not be financed or would be financed at higher costs by other creditors).

### *Summary*

The ex-post odious loans framework creates an unambiguous increase in legal costs, and thus is likely to be pursued primarily where the prospect of full cancellation, compared to a partial cancellation possible under the current legal framework, compensates the higher legal costs.

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<sup>24</sup> Of course, these legal costs would not apply if a creditor would announce unilaterally the cancellation of certain loans since in this case the borrowing country would not repudiate on its loan. Norway announced, for example, in 2006 that it would unilaterally and without conditions cancel US\$80 million in Ship Export debt owed by 5 countries. The Government stated: “The [Ship Export] campaign represented a development policy failure. As a creditor country Norway has a shared responsibility for the debts that followed. In cancelling these claims Norway takes the responsibility for allowing these five countries to terminate their remaining repayments on these debts.” Norway also indicated that the unilateral cancellation of the ship export debt would be implemented outside the cooperative framework of the Paris Club of creditor countries, but that this unilateral forgiveness would be a one-off debt relief policy measure and that all future debt forgiveness would be effected through multilaterally coordinated debt relief operations. See: <http://www.regjeringen.no/nb/dep/ud/Pressesenter/pressemeldinger/2006/Cancellation-of-debts-resulting-from-the-Norwegian-Ship-Export-Campaign-1976-80.html?id=272158>

Also, borrowing costs (or the increase in costs post-repudiation) would go up due to stricter due-diligence or lower expected returns. Moreover, depending on how broad the definition of “odious loan” is, there could be a tendency for both commercial and official creditors to shy away from riskier projects that nonetheless have high ex-ante returns and would therefore be in the interests of the country’s population.

**Table 5: Ex-post Odious Loans – Summary of Costs**

Creditor/Cost	Legal	Market
Commercial	Higher, but work-out could be more favorable.	Pre- and/or post-default costs higher due to increased due-diligence or reduced expected returns.
Official	Higher, especially if definition of “odious” is ambiguous.	Lower incentives to lend into “risky” projects that might be declared “odious”.

## 2.2. Ex-ante framework

The ex-ante odious loans framework is related to the concept of “responsible lending”, since it would require lenders to abide by certain lending standards (e.g., the Equator Principles). However, if it would go beyond a “responsible lending” framework, since loans that do not comply with pre-defined standard could be questioned on legitimacy grounds. On the other hand, once a loan is judged to have met those standards, it cannot be repudiated on the basis that it is illegitimate, including, for example, in the case where the project fails or where it is later discovered that the money was used other purposes than originally intended.

The costs of an ex-ante odious loan framework, especially for **commercial creditors**, would depend on the ex-post status of loans that do not meet the “responsible lending” standard. If loans that do not meet the standard are regarded as legitimate and enforceable, governments and creditors would be able to effectively opt out of the framework. The second possibility would be for a loan that does not meet the standard to be unenforceable (i.e. it is by default assumed to be illegitimate). A third possibility – that loans that are not covered could be litigated as to their legitimacy – is equivalent to the ex-post approach since the key difference between ex-ante and

ex-post frameworks lies in the parties' knowledge of the legal implications of repudiation in the former, but not in the latter framework.

In the first scenario (where loans are by default enforceable), one might expect that most countries and creditors would wish to avoid the high costs of due-diligence beyond that which is legally required to guarantee enforcement (i.e. comparable to what exists at present) and would opt out of the framework, in which case costs would not be affected. On the other hand, commercial creditors may welcome such a framework as it helps their reputation for corporate social responsibility. Moreover, if the loans could be questioned ex-post, participating in the framework would likely improve the likelihood of enforcement. We consider below the implications of a stronger version of the current system – namely declaring all non-compliant loans to be, in principle, illegitimate.

The effect of this framework on the litigation costs (such as lawyers' fees) related to commercial debt is unclear. On the one hand, there would be more elevated costs to certify that loans meet the framework's criteria. On the other hand, ex-ante frameworks generally reduce the need for legal proceedings since they preclude arguments of illegitimacy if the government were to try to repudiate a loan that was certified to meet the standards of the framework or if creditors tried to recover on a loan that was not certified as meeting the appropriate standards.

Market costs of repudiating loans not meeting the standards of the framework are likely to be lower, as creditors that adopt the framework are unlikely to coordinate with a non-participant in punishment lest they provide incentives for free-riding by those creditors. Costs of pre-default financing would increase, however, for all countries, proportionally to the increased cost related to adopting the policy. Note that such an increase is not seen in interest rates charged, but it is customary for commercial creditors to deduct loan preparation costs – including due-diligence costs – from the proceeds, thus increasing the “all-in” cost of the loan.

Compared to the other policies, the incentive for regimes to default on legitimate debt is probably the lowest because even “odious” regimes retain access to finance for certain projects,

but are probably still higher than under the current situation without any odious debt policy because the cost of verifying the legitimacy of loans to certain regimes will be prohibitively high.

By avoiding all ex-post legal proceedings and building on existing due-diligence practices, the ex-ante odious loans framework would likely reduce overall legal costs of restructuring debt to **official creditors**, however, borrowing costs of these creditors would increase. And similarly, to the ex-post loan approach, official creditors may shun away from projects where the costs of meeting the proposed standards would be very high, even if these projects might be in the interest of the population.

### *Summary*

The ex-ante odious loans framework (with the assumptions that loans not meeting the framework's standards are not enforceable) presents some attractive features relative to the other proposals – most notably, it does appear to actually reduce ex-post legal costs without a substantial increase on market costs for both commercial and official lenders. However, these benefits are not without their costs: increased due-diligence requirements would increase overall borrowing costs, which will largely be borne by all borrowers, including those with adequate control systems. Moreover, costs would especially increase for high-risk projects, which may not be desirable if those projects also have low returns.

Most importantly, designing such a framework would be challenging, especially since most benefits hinge on very well-defined ex-post expectations. Current governments, especially of market-access countries, and their creditors are unlikely to favor a system that would force all loans to require costly due-diligence expenses, especially if the requirements are broad.

**Table 6: Ex-ante Odious Loan – Summary of Costs**

Creditor/Cost	Legal	Market
Commercial	Higher ex-ante, lower ex-post if legal status of non-complying loans is clear.	Higher due to due-diligence, but lower costs to repudiate on non-complying loans.
Official	Ex-ante costs may increase, for example as a result of increased legal costs for certifying the compliance of projects with the framework; similar or lower ex-post costs if legal status is clear.	As above, assuming due-diligence costs and default rates generally similar.

#### IV. CONCLUSION

Although the objective of ensuring that governments use the proceeds from external loans for the benefit of their population is a laudable one, “odious debt” frameworks are unlikely to offer a costless solution. The policies proposed by CSOs (with the possible exception of the ex-ante loan policy) do little to unambiguously reduce the costs of defaulting on loans deemed to be illegitimate – and therefore to dissuade lending for illegitimate purposes. Frameworks based on regime type definitions pose tremendous challenges for the body or bodies charged with adjudicating on the type of regime, and in addition generate incentives for despots to default, especially to those creditors most committed to the goals of the framework. Frameworks based on individual loans entail high direct legal costs – whether of auditing loan portfolios and litigating or certifying that each loan complies with the framework’s standards. Ex-ante frameworks appear superior to ex-post ones as they minimize the impact on non-odious governments, although they do not remove all uncertainty: many countries will be penalized for the probability of being declared odious even if they never turn out to be, and worthwhile but risky projects may not be undertaken.

The “ex-ante odious loans” policy seems to be the least distortionary. Although it entails high ex-ante costs, if well-designed it could improve the use of loan proceeds while minimizing other effects. However, it would still lead to a substantial increase in borrowing cost. And most importantly, even a well-designed ex-ante odious loans policy does not avoid the problem with the fungibility of resources: if odious regimes cannot borrow to buy weapons or line their “private” bank accounts, they may use domestic revenues or exploit natural resources more intensively. Any loan-by-loan approach is only effective in ensuring that loan proceeds are used in the interest of populations living in countries where a large volume of financial flows is external loans, which is not the case in most countries, but particularly applies to low-income countries. As a consequence, the proposed odious debt policies are most likely to increase the borrowing costs in those countries that require access to relative cheap external loans in order to finance their development needs.

Perhaps more importantly, a loan-by-loan approach – or indeed any framework that focuses exclusively on debt – would not address the important issues of improving public financial management and building and using domestic budget monitoring systems – i.e. to build the capacity for the country’s own population and civil society to monitor the expenditure of all resources administered by the state – not only those that arise from external borrowing. In sum, our analysis suggests that the economic costs of “odious” debt policies are non-trivial and they should be carefully considered by governments and organizations involved in this debate.

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