

Briefing on Odious Debt
Berlin, Germany
June 4, 2008

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When the development community meets later this year in Doha, Qatar, to review progress in pursuing the Monterrey agenda on finance for development, there will be a mix of good and bad news. Most developing countries have significantly improved their macroeconomic stance and their capacity to mobilize domestic resources since 2002. Yet, progress in terms of ODA scaling up and with respect of promoting a development-oriented trade agenda remains limited.

There is one area, however, where significant progress has been achieved: debt relief. Through the Heavily Indebted Poor Countries (HIPC) Initiative (created in 1996 and enhanced in 1999) for Low-Income Countries (LICs) and the Multilateral Debt Relief Initiative (MDRI: created in 2006), 33 LICs have qualified for debt relief, worth over US\$110 billion over time (if all creditors provide their expected share of debt relief) another 8 countries are potentially eligible. For these countries, the World Bank alone is expected to provide debt relief totaling about \$44 billion (\$15 billion under HIPC and \$29 billion under MDRI). And if all potentially eligible countries qualify, this could rise above \$54 billion.

In short, this has been an agenda that has moved forward in a significant manner since the 1990s and civil society organizations (CSOs), both in the South and in the North, have played a critical role in fostering these achievements. Still, there is in some quarters a sense of frustration and a feeling that more could be achieved, not only in terms of the scope of debt relief, but also with respect to the coverage of beneficiaries. This has translated in the renewed interest in the concepts of “odious” and “illegitimate” debts.

It is important to recognize upfront that the moral outrage associated with misuse of foreign loans is not the monopoly of CSOs. In addressing some of the questions posed by the organizers of this event, however, this note illustrates the limits of these concepts and discusses alternative instruments that can deliver debt relief. It also addresses the concept of responsible lending (i.e., the idea that the lender should take some joint responsibility for the outcome of the lending whether a specific project or broader concerns such as minimizing the chance of misuse of proceeds).

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What are illegitimate debts and how did they come about? How have international policymakers coped with the problem?

There's a growing international campaign of some civil society organizations against "odious" or "illegitimate" debt, terms that seem to encompass very different notions of debts' legality. However, the name most often linked to the doctrine of odious debt is Alexander Nahum Sack, who in 1927 identified three categories of odious debt:

- incurred by regimes that have used the proceeds to wage wars against other countries ("war debt");
- incurred by regimes that have used the proceeds to subjugate a people or colonize its territory ("subjugation debt");
- incurred by a despotic regimes to contract a debt, not for the needs and in the interest of the states, but to strengthen its own despotic regime ("regime debts");

There have been cases, in state practice, where a successor state has rejected debts contracted by a predecessor state to sustain its war effort against the former -- for example, when Great Britain annexed Transvaal in 1900 after the Boer War. There exists, however, also cases where successor states assumed the war debts of predecessor states, such as the assumption of a percentage of the Austrian war debt by the former Czechoslovakia after the First World War.

The classic case of rejection of a subjugation debt is the repudiation, by the United States, of the Cuban debts contracted by Spain allegedly on the ground that they had been imposed on Cuba against its will and that they had not been contracted for Cuba's benefit, but only to keep Cuba under Spanish domination and to suppress Cuba's war of independence. The 1898 Treaty of Peace, which ended the dispute, stated that neither the United States nor Cuba assumed "subjugation debts" contracted by Spain. However, the practice of states has not been consistent with respect to subjugation debts and it remains questionable whether a customary rule allowing the repudiation of subjugation debts exist.

Arguments based on the non-enforceability of war and subjugation debts have been used within the context of state succession. The case of regime debts is different since it argues that despite the continuity of the state, there has been a change in government and the successor government refuses to honor the debts contracted on account of they having been contracted in the exclusive interest of the predecessor regime. The traditional example is that of the loans extended by the Royal Bank of Canada to Frederico Tinoco, who was head of the Costa Rican government. The loans were contracted a couple of months before Tinoco left the country. Great Britain started arbitral proceedings against Costa Rica to force the new Costa Rican government to honor Tinoco's debt. The sole arbitrator held that the transactions involving Tinoco were full of irregularities and the Royal Bank of Cana knew that the money would benefit Tinoco, not the state or the people of Costa Rice. However, in this arbitral award there was no recognition of any

international customary norm allowing a successor government to repudiate the debts contracted for personal gain by the predecessor government.

While war/subjugation/regime debts were identified by Sack as the three categories of debt, the concept of odious debt has since been expanded by many writers to include notions of “criminal” debt (i.e. loans linked to corruption and bribery) and what one might label “ineffective” debts (i.e. loans that do not reach their developmental purpose and loans directly linked to capital flight). However, it is important to note that even within the strict limits of Sack’s concept of odious debt, no customary international rule (let alone the stronger concept of a norm of *jus cogens*) allowing the repudiation of odious debts seems to have emerged from the scattered instances of state practice and arbitral decisions, nor has any codification treaty embodied an exception based on the odiousness of the debt.²

The expansion of the notion of illegitimate debt has introduced further complexities. First, instead of a case-by-case analysis of individual loans with a view to determining whether they have given rise to odious debts, there is a tendency to proceed to an overall assessment not so much of the financial transactions in question as of the “odious” nature of the borrower (i.e. there would be “odious” debtors rather than “odious” debts). Such an extension rests in part on the concept of fungibility, namely that loans ostensibly provided for one purpose can release monies already allocated for that purpose to be used for an entirely different purpose, with or without the knowledge of the lender. Second, greater emphasis is placed on the lender’s actual or presumed knowledge (and ensuing accountability) or the extent of due diligence to obtain knowledge of how the borrowed funds will be used by the borrower. Third, unlike Sack’s concept of debt, there is no appeal to any international customary rule that would justify the new concept and categories, the stress being rather on the moral or political unacceptability of repayment.

Given these complexities, it is therefore not surprising that Iraq and South Africa, just to take two recent examples of countries with new governments that inherited large sovereign debts, chose not to repudiate those debts unilaterally on grounds that they were “odious,” but instead chose to negotiate a debt restructuring with their creditors.

Finally, it is important to recognize that the debate on alternative statutory/legal options for addressing sovereign debt restructuring is not a new theme. The debate on the Sovereign Debt Restructuring Mechanism proposed by the IMF in the early 2000s illustrates this.³

² For further details see Nehru and Thomas (2008).

³ See Krueger, Anne (2002) “Sovereign Debt Restructuring Mechanism: One Year Later,” note presented at the Banco de Mexico’s Conference on “Macroeconomic Stability, Financial Markets and Economic Development,” Mexico City, November 12, 2002. In that note Krueger refers to the Annual Report of the Corporation of Foreign Bondholders of 1874 as a further illustration of the perennial character of this debate. In the report in question it is noted that “During the autumn of last year, a conference of jurists and public men of various countries ... [discussed] ... the possibility of international agreements upon the principles of law which should determine the liability of sovereign states and foreign subjects in their

What impact have liabilities arising from illegitimate debts had on development cooperation?

International practice generally holds sovereign borrowers responsible for the use of the borrowed funds in accordance with applicable law and contractual obligations. Shifting the responsibility for the “effective” use of funds from the borrower to the lender, *ex post*, may deter development lending. Moreover, the proposition that “odious debts” be forgiven could *encourage* the misuse of loan proceeds, since a corrupt borrower could borrow in the expectation that misuse now would lead to debt forgiveness later.

How has the international debate developed in recent years, with special regard to the role of the World Bank, IMF, UNCTAD, the member states of the G8, and countries such as Norway in particular, but also the efforts of the Federal Ministry for Economic Cooperation and Development?

The difficulties in agreeing on a definition of odious/illegitimate debt should not deter lenders and sovereign borrowers from acting in a variety of ways to ensure that public loans are used for the benefit of the borrowing states and not to enrich the corrupt. Actions taken by The World Bank Group (WBG) illustrate this approach. The World Bank has a fiduciary responsibility to its stakeholders to ensure that development funds are used for the purpose intended, and not jeopardized by corruption and has scaled up its already substantial focus on governance assistance, using a wide range of mechanisms to reduce the probability of corruption in lending:

- The Bank helps strengthen governance and address corruption through *projects and programs* that improve transparency in public financial management; strengthen tax and customs administration; enhance civil service performance; support legal and judicial reform; combat corruption; and enable local and central governments to deliver services and regulate the economy more effectively.
- The Bank is a leader in the development and application of *governance diagnostics*, such as Doing Business reports, Investment Climate surveys, Public Expenditure and Financial Accountability (PEFA) indicators, World Bank Institute’s (WBI’s) Governance and Anticorruption country diagnostics, and the WBI Governance Indicators.
- The Department of Institutional Integrity (INT) investigates allegations of *fraud and corruption in Bank-financed projects* – inside and outside the Bank – and refers its findings to the Bank’s Sanctions Management system. Since 2001, the *Integrity Department* has handled close to 3,000 cases of alleged fraud, corruption, or other wrongdoing, resulting in the public debarment of 340 companies and individuals, whose names have been listed on the Bank’s website. When appropriate, the

relations to one another. ... There can be no question as to the advantage that would result from such an agreement."

Department also refers its findings to the prosecutorial authorities of relevant member countries for further action. INT is now incorporating lessons from past investigations upstream in project design and program development.

- The Bank is also an active participant in promoting the OECD *Convention on Combating Bribery of Foreign Public Officials* (1997), the UN *Convention Against Corruption* (2003), the *Extractive Industries Transparency Initiative* (EITI) (2002), and the *Forest Law Enforcement and Governance* (FLEG) Ministerial Processes, among others.
- The Bank, with the support of the Government of Norway, has prepared a discussion paper (see Nehru and Thomas, 2008, fn. 1) and organized a roundtable for debating (with CSOs and other stakeholders) conceptual and operational issues of lender responsibility for sovereign debt (April 2008).

Initiatives to promote good lending practices can be complemented by new initiatives to strengthen the array of anti-corruption measures that countries can implement, such as for example, the Stolen Asset Recovery Initiative (StAR). In September 2007, the Bank launched the **StAR initiative**, in partnership with the United Nations Office on Drugs and Crime, to help developing countries recover and channel assets stolen by corrupt leaders towards effective development programs. The initiative aims to strengthen the institutional capacity of government agencies to locate and repatriate stolen assets. It also calls for developed nations to assist proactively in the recovery of stolen assets and for greater global and bilateral cooperation. It also sends strong signals to corrupt leaders that they cannot escape the law. In recent years, countries as diverse as Nigeria, Peru, and the Philippines have enjoyed some success in securing the repatriation of assets stolen by their corrupt former leaders.

What are the current aspects of the debate on illegitimate debts?

Recently a proposal has been put forward, most notably by Michael Kremer (department of Economics, Harvard University), to have some internationally accepted entity or individual declare *ex ante* that certain regimes are odious. The argument is that this would put lenders on notice that loans to such regimes could be repudiated by successor regimes with the support of the international community unless, the lender can demonstrate that due diligence had been used to ensure the loan proceeds were used for legitimate purposes.

The implementation of such an approach, however, would encounter many challenges. Some of the questions posed by analysts evaluating such an approach include:

- (i) Who would declare *ex ante* regimes as odious?
- (ii) Which factors would distinguish odious from non-odious regimes (e.g. denial of fundamental human rights, ethnic cleansing etc.)?
- (iii) How would such declarations be treated in national courts?

It is also worth noting that nothing prevents governments today from prohibiting lending to regimes that they consider “odious,” either unilaterally or through their participation in international organizations.

Perhaps, the most important factor motivating the call for the cancellation of odious debts is the conviction that loan proceeds are often embezzled by corrupt officials and leaders in the borrowing countries, leaving it to future administrations and generations to pay back the debts having received none of their benefits. Such practices deserve not only moral outrage, but also a thoughtful reaction on how to deal with them most effectively. For example, external lenders could commit to follow good lending practices, such as including anti-corruption plans in projects, examining governance standards in the borrowing country, implementing anti-corruption mechanisms.

What effects are illegitimate loans having on financial markets?

Improving lending practices has also been pursued by important commercial creditors. Fifty-two of the world’s most prominent commercial financial institutions have endorsed the Equator Principles, a set of ten benchmarks against which these institutions have agreed to determine, measure, and manage the social and environmental risks associated with project financing.⁴ One of the key motivations for this initiative was the perceived importance of mitigating credit and reputational risk. Supported by the International Finance Corporation (the private-sector lending arm of the World Bank Group), the Equator Principles also facilitate collaboration and learning between member financial institutions on the interpretation and application of broader good-practice lending policies.

How should the term "moral hazard" be understood in relation to illegitimate debts?

Moral hazard is a term coined in the insurance industry to indicate the problem that unobservable actions by the insured might actually worsen the odds of the eventuality insured against occurring. The term may be seen to apply to project outcomes if these – as they surely do – depend on the actions of the borrower. Moral hazard exists if there is a sense that the cost of failure of loans would be borne by others, weakening borrowers’ incentives to work for good project outcomes. National financial laws do not require lenders to pay the costs for project failure for two reasons: first, the act of lending usually cannot be considered the proximate cause of the failure of the project or activity, under any scenario; second, and more importantly, it could potentially create incentives for irresponsible behavior by borrowers (i.e., foster “moral hazard”), because the costs would be born by the lenders. In economic terms, debt contracts are “incentive compatible” with maximizing the chances of project success, because they make those responsible for project execution – the borrowers – the sole beneficiaries, at the margin, of that success.

⁴ See <http://www.equator-principles.com/index.html>.

What possibilities exist of stopping the practice of granting illegitimate loans?

International monitoring and guidelines (as the OECD Principles and Guidelines to Promote Sustainable Lending in the Provision of Official Export Credits to LICs) can help. With respect to its own practices as a lender, the Bank pursues a series of policies to ensure that development funds are used for the purpose intended:

- All new commitments of grants or loans are subject to strict scrutiny and oversight prior to approval and during project and program implementation.
- The Bank has clear rules and procedures which it does not hesitate to use for dealing with the misuse of its loans and grants, including the cancellation of the loan or early repayment of disbursed sums.
- The Bank contributed to the drafting of the UN Convention Against Corruption and is helping to write the technical guide to its implementation. It helps countries enhance their ability to track, freeze, and confiscate the proceeds of corruption, and assist in international efforts to help developing countries recover and reconstitute stolen assets.
- As the recent experience with asset recovery in Nigeria shows, the Bank can provide important assurance that such restituted assets will be put to good use in the developing country from which funds were taken.
- The Bank is also an active participant in international anti-money laundering efforts.

What role could international standards play in this process? What effects would international standards have?

Implementing standard on lending practices could help to mitigate credit, social and environmental risks associated with project financing. Disclosing pecuniary and non-pecuniary risks of lending to shareholders as well as borrowers may reduce the probability that inefficient loans are contracted. They could also provide guidance and strengthen the incentives of lenders to behave responsibly, but they should not rely on intrusive new regulation.

What criteria could serve as a basis for such standards?

There is a large array of criteria and actions that could serve as the basis for developing standards for improving lending practices. Some examples are as follows:⁵

- “Projects considered at high risk of corruption could be required to include anti-corruption action plans that build on knowledge gained from the experience of implementing previous projects, and which draw on tried-and-tested requirements for transparency and oversight, possibly including enhanced disclosure provisions, civil society oversight, complaint-handling mechanisms, policies to reduce opportunities for collusion, mitigation of fraud and forgery risks, and specified sanctions and remedies.

⁵ See Nehru and Thomas (2008, pp.30-36) for further details.

- Well publicized mechanisms should to be put in place, allowing the public – and internal “whistleblowers” – to come forward if they have allegations of corruption, with adequate safeguards to protect them against possible reprisals. Such allegations will need to be investigated thoroughly by the lender as well as the borrowing authorities, in full conformity with national laws and regulations. Any evidence emerging from investigations of wrongdoing should be made public and handed over to authorities for appropriate action consistent with the laws and regulations of the country concerned.
- Mechanisms for the debarment of firms and individuals that are found to be participating in fraud and corruption should also be utilized. Every effort should be expended by governments and the international community to recover stolen government assets, including money stolen from sovereign loans.
- Providing ample opportunities within the country to comment on, criticize, and shape the proposed loan, and stressing a country representative’s freedom to decline the loan throughout its preparation, appraisal, and approval process.
- Subjecting loans to intensive preparation, evaluation, appraisal, and negotiation, with full participation by the authorities of the country concerned and, where appropriate, by civil society and other relevant groups, and disclosing to the public the final appraisal documents. Depending on the applicable laws, regulations, and procedures, this could include scrutiny by elected representative bodies.
- Requiring legal opinions regularly, from acceptable counsel, confirming that the loan agreement in question is legally binding in accordance with its terms and has been approved in conformity with the internal laws and procedures of the borrowing country.
- Covenants in loans could expressly require that the loan proceeds be used for their intended purposes, and subsequent supervision efforts, in which the borrower and the lender cooperate, should be designed to ensure that proceeds are being used for and achieving their intended purposes.
- Lending institutions could regularly conduct – together with the sovereign borrower’s authorities – evaluations of the use of their loan proceeds and whether such loans have achieved their intended purposes. These evaluations may be conducted independently of the management of these institutions and the results could be made public.”

What should be the role of G8 member states, and what should be the contribution of agencies like the World Bank, the IMF and UNCTAD? What can Germany do to influence these institutions?

The Bank Group considers itself as having a fiduciary responsibility to its stakeholders to ensure that development funds are used for the purpose intended, and not jeopardized by corruption and has currently scaling up its already substantial focus on governance assistance. Initiatives to promote good lending practices can be complemented by new initiatives to strengthen the array of anti-corruption measures that countries can implement, such as for example, the Stolen Asset Recovery Initiative. It is also important to support the scaling up of technical assistance to improve capacity for

debt management in client countries. And when debating new measures such as international charters, it is important to recognize that would not be a constructive outcome if a small subset of international lenders signed up to stringent standards and the majority opted out. Such measures should be designed with a view to make their adoption feasible for most (if not all) participants in these “industries.”

Is it possible to estimate the size of long-standing liabilities which developing countries have accumulated from illegitimate debts? How can further debt-reducing initiatives help in dealing with illegitimate debts?

As stated above, the concept of “odious debt”/“illegitimate debt” means many things to many people. It would require a precise definition of the debt in order to come up with estimates.

Needless to say, it is important that developing countries, especially low-income countries, have access to the financial resources needed for their development without building up unsustainable debt levels. Accordingly, financing, especially, to low-income countries should be provided on sufficiently concessional terms, allowing these countries to maintain their debt at sustainable levels. It is worth noting that under IDA14, as well as under IDA15, IDA grants are used for the objective of mitigating debt distress risks detected by Debt Sustainability Analyses.

Levels of unsustainable debt in countries that do not qualify for the HIPC Initiative have been dealt with in the context of traditional debt relief mechanisms. Unilateral repudiation as suggested by the literature on odious/illegitimate debt may come at a high cost, potentially cutting off their access to international financial flows. This may be one reason why borrowers tend not to pursue this route. As already noted, even countries such as Iraq and South Africa which inherited large sovereign debts chose not to repudiate those debts unilaterally on grounds that they were “odious,” but instead chose to negotiate a debt restructuring with their creditors.

Concluding remarks

The debt of the poorest, most heavily indebted countries has been reduced substantially in recent years in the context of the HIPC Initiative and the MDRI. So far, as already pointed out, 33 countries have benefited from HIPC debt relief. In these countries, reforms have been reinforced, the ratio of debt service to exports cut by two-thirds on average, and pro-poor spending increased, from \$6 billion to \$20 billion a year since 1999.

In addition, IDA administers the Debt Reduction Facility (DRF) for IDA-only countries (created in 1989). The DRF’s objective is to help heavily indebted, IDA-only countries reduce their sovereign commercial external debt as part of a broader debt resolution program). To encourage commercial creditors to bear their share of HIPC debt relief, the DRF provides grants to eligible HIPCs to buy-back their eligible commercial debt at a

deep discount (consistent with the requirements under the HIPC Initiative). The DRF is financed from transfers from IBRD net income and grant contributions from other donors, as well as investment income earned on such contributions.⁶

By relying on these initiatives and instruments, as well as methodologies such as the debt sustainability framework for LICs, and by supporting capacity building in the area of debt management, the development community can further advance the agenda of responsible lending. This is in our view the most effective way to deal with the challenges that are being discussed in this seminar.

In short, the debate should move away from the false dichotomy that “countries must either pay their unsustainable debts or repudiate them” as illegitimate debts. By improving existing lending and borrowing practices in the context of the responsible lending agenda, creditor countries (as illustrated by the recent actions of the Norwegian government unilaterally cancelling claims from the Norwegian Ship Export Campaign), multilateral creditors (via international debt relief initiatives such as HIPC and MDRI), commercial creditors (by subscribing to the Equator Principles) and debtor countries (by improving their debt management practices and pursuing economic/institutional reforms that promote transparency and economic growth) can all contribute to pragmatic and concrete solutions to foreign debt problems.

⁶ Since its establishment, the DRF has supported 24 completed (or very largely completed) commercial debt reduction operations in 21 IDA-only countries. In these operations, about US\$4.8 billion of external commercial debt principal and an estimated US\$4.2 billion of associated interest arrears and penalties have been extinguished. To extinguish this total of around US\$9 billion of debt principal and interest, resources of about US\$712 million have been utilized. Recent commercial debt reduction operations in Mozambique and Nicaragua have together extinguished just under US\$1.5 billion of commercial external debt at a cost of US\$75 million including adviser fees, and with creditors providing debt relief more than comparable with that provided to the country by other classes of creditor under the HIPC Initiative. More than half of the costs of these buybacks have been mobilized from bilateral contributions, including from Finland, the Netherlands, Norway, the Russian Federation, Sweden and the United Kingdom. Work is now under way to prepare and implement a commercial debt reduction operation for Liberia.