Recensione del Volume:

Rethinking Sovereign Debt[◊]

Policy, Reputation and Legitimacy in Modern Finance

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1. – Overview

Rethinking Sovereign Debt explores how sovereign debt continuity –the rule that nations should repay debts even after a major regime change, irrespective of the legitimacy of the previous regime– became customary international law. In fact, the consensus approach is that debt should be repaid even if it is odious, say, because it was incurred by a tyrannical government that did not respect human rights, repressed oppositions, made a private use of borrowed funds, etc. Continuous debt repayment, irrespective of regime changes, is indeed the common practice that has earned the rank of a market principle in the eyes of scholars and financial investors. Odette Lienau shows instead that, far from being a market necessity, debt continuity is just the consequence of the historical prevalence of a statist theory of sovereignty according to which the debtor is the State, and any government that exerts the control of the territory is the State's legitimate representative.

Rethinking Sovereign Debt is more than a book on odious debt; in Lienau's words "[the aim is] to explain the foundation for the norm of sovereign debt continuity… to understand how the norm of sovereign debt continuity gained power in modern finance to the near exclusion of other possible approaches." Lienau's analysis is important because "The way in which we think and speak about debt continuity acts as a kind of global soft law, shaping expectations of appropriate action for borrowers

[◊] Harvard University Press, Cambridge, Mass., 2014, ISBN 9780674725065, pp. 344.

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and lenders… it enables and promotes particular outcomes and make contrary approaches seem implausible."

Lienau combines international law, politics and economics to shed light on the historical and political determinants of the contemporary norm of debt continuity, arguing against continuity as an inevitable market principle. The focus is on regime changes more likely to result in odious debt claims, such as social revolutions rejecting the legitimacy of the previous regime or post-dictatorial democracies inheriting debt spent on corruption if not on the repression of dissent and opposition. The aim is to understand how contingent historical and political factors as well as financial market structures determined behavioral pathways that made the debt continuity approach prevail and consolidate over time. By showing that the norm of 'debt repayment under all conditions' is historically specific, and more nuanced views of repayment existed in the past, Lienau argues that alternative more flexible approaches were possible and could be invoked in the future to deal with the debt obligations of previous odious regimes.

2. – Book Structure

Lienau argues that the debt continuity rule depends on both the prevalence of a statist view of sovereignty and creditors' coordination/cohesion. In fact, there exist other theories of sovereignty, which are discussed in Chapter 2, such as popular sovereignty, respect of internal laws or output oriented sovereignty, that would imply a more flexible approach to debt repayment. The conception of sovereignty and creditors' cohesion determine the extent to which the norm of continuous repayment is dominant. More flexible notions of repayment emerge when democratic or legal visions of sovereignty challenge the dominant statist approach and when new lenders competing with old creditors provide defaulting governments with renewed access to financial resources. The case studies which follow the theoretical chapters provide specific examples of how these two factors interacted to determine repayment outcomes in historical episodes of major regime changes.

More flexible approaches to debt repayment are present in post-World War I cases of Soviet Russia's repudiation of Tsarist debt and Great Britain's 1923 arbitration with Costa Rica, favored by new ideas of sovereignty based on Woodrow Wilson's commitment to self-determination and constitutional government (Chapters 3 and 4). While odious debt claims of post-revolutionary Soviet Union were rejected and the country was excluded from international capital markets, US chief justice Taft ruled in

favor of Costa Rica in its dispute against Britain over the debt incurred by previous Tinoco's dictatorship on the basis of violation of internal laws (consistently with a rule-of-law approach to sovereignty). By demonstrating the interest of US banks in financing the new regimes, and the decisive role of the US government in preventing banks from lending to Soviet Russia, Lienau argues that creditors can reasonably make reputational judgments in favor of post-repudiation lending and challenges the assumption of an inevitable negative reaction of finance to debt repudiation.

Debt continuity reemerges as a strong norm immediately after World War II, at a time when lending to sovereigns was a shared monopoly between the US government and the World Bank (Chapter 5). The latter played an important role in consolidating the statist approach as it considered only economic reasons for its lending decisions, consistently with its Articles of Agreement that explicitly exclude a role for political considerations (see Section 10 Article IV). This 'political neutrality" was partly motivated by the early dependence of the Bank on private financial markets for the funding of its financial operations and thus on the need to adopt similar practices. Yet, Lienaus's vivid account of the Bank's refusal to stop lending to Portugal and apartheid South Africa in the mid-1960s, despite the explicit request by the United Nations, is reminiscent of the grim origin of international debt finance. This system also conformed with the interests of newly independent States that found in the statist understandings of sovereignty an easy way to legitimate themselves in the international political arena.

By the 1970s bank syndication had become the predominant method of private lending. The resulting interconnections of banks' loans and risks favored a coordinated creditors' common approach to the debt crisis and loan restructuring of the 1980s, that limited the space for non-statist claims about debt discontinuity (Chapter 6). This trend was, in turn, reinforced by the general debtor response that focused on broader inequities in the economic system rather than on arguments based on political discontinuity. Quite surprisingly even the revolutionary governments of Nicaragua, Iran, the Philippines, and South Africa ultimately acknowledged the debts of previous regimes despite their despotic or racist nature. This evidence, as discussed below, highlights how costly is repudiation compared to renegotiation and restructuring.

Since the 1990s attention for the values of human rights and popular sovereignty, including claims to self-determination has intensified and even international economic organizations have adopted this language to some extent. These developments have helped bring ideas of odious debt into the light, as evidenced by the discussion in the Iraqi case. Although expectations of uniform repayment still

dominate, Lienau is confident that "the distance between conceptions of legitimate sovereign action in the political and financial realms may shrink in future years."

3. – Lessons for Economists

Why should economists be interested in a book on odious debt written by a law professor? The first reason is that it provides a comprehensive and particularly rich analysis of historical episodes of debt default/repudiation associated with major regime changes. By combining knowledge of international law, politics and economics this review provides us with a wider perspective on sovereign debt issues and with new instruments to better understand debt default/repudiation issues and debtor-creditor relations.

Important lessons can be learned from Lienau's account of historical episodes of regime changes that could result in odious debt claims. Economists have long and still struggle to explain why sovereign debt exists given that sovereign indemnity prevents creditors to take legal actions against a defaulting borrower that refuses to repay. Panizza et al. (2009) review the main theories of the costs of debt default that should ensure repayments: exclusion from future credit; trade disruption; domestic costs due to financial sector failures and reputational/institutional damages. However, the empirical evidence casts serious doubts on the extent and relevance of such costs. Consistently with the seminal contribution of Grossman and Van Huyck (1988), costs may not be observed or be small because punishment in the form of reputational costs or trade sanctions is not exercised if defaults are 'excusable', say, because of bad economic conditions and external circumstances. In the latter case creditors should be willing to renegotiate/restructure the debt. In other words, high default costs may never be observed, because they would play a role only "out of equilibrium" in deterring 'not excusable' default.

While the enforcement mechanisms of sovereign debt repayment are not yet fully understood, Lienau shows that countries renegotiate and partially repay sovereign debt even when such debt is odious. She reminds us of the distinction between repudiation and default; while default is excusable and renegotiation is the norm, outright repudiation, even when principled on odious debt claims, is unacceptable by the international community of States, public and private financial institutions. Apparently, a similar conclusion is reached in a recent report by Buchheit et al. (2013): "repudiations

would be severely punished (and as a result, would never occur), while shocks to debt service capacity would lead to a corresponding adjustment in the debt burden without any punishment."

In fact, Lienau reports very few cases of principled repudiation over the last century: Soviet Russia's repudiation of Tsarist debt; People's Republic of China's repeal of treaties, agreements and debts of previous regimes, and; socialist Cuba's nationalization of foreign investments and repudiation of external debt. These deliberate actions resulted in an effective isolation of such countries from international relations besides their effective exclusion from international capital flows. Although it is fair to say that politics more than financial markets played a role in the breakdown of economic relations, the costs of repudiation are undeniable. The hardship that Cuba suffered from isolation in the aftermath of the revolution likely shaped the decision by the Sandinista government of Nicaragua to renegotiate rather than repudiate Somoza's odious debt. The decision to restructure and partially repay external debt by other Latin American countries emerging from military dictatorships in the 1980s was based on similar grounds. In fact, in many other cases, from post-Marcos Philippines to Iran, from post-apartheid South Africa to Iraq, acknowledging odious debt and renegotiating it at favorable terms were preferred actions as they involved lower economic (and political) costs than repudiation. For instance, the restructuring of Saddam Hussein's debt led to an almost 90 percent haircut; probably, a better outcome than what Iraq would have achieved with selective repudiation. Moreover, even if we take Lienau's argument that repudiation may not necessarily have reputational consequences for newly established governments and their creditworthiness, acknowledging the debt of past regimes 'under all conditions' is a an easy way for such governments to rapidly gain credibility in the international political arena.

There is however another reason why governments tend to repay the debts of previous illegitimate regimes that transpires from Rethinking Sovereign Debt. The statist conception of sovereignty, that underpins the debt continuity norm, entails "the idea that the content of and changes in a State's internal structure, interests, and popular support are irrelevant to its status as a legitimate sovereign and thus to its external relation" and, as a result, that lending, as any economic relation, should be void of political judgment. The current approach in modern finance that refuses political assessments and makes reputation depend only on repayment record is not only easier for private creditors but it also fits the interest of debtor governments that oppose any interference in their internal affairs and external limitations to their actions.

4. – Policy Considerations

Although I am sympathetic to the idea of odious debt cancellation, I am less optimistic than Lienau about the possibility of a change in the practice of sovereign debt despite the increasing attention and sensibility to new theories of sovereignty in international law and politics. As the norm of debt continuity is rooted in the statist theory of sovereignty, it is unlikely that exceptions to the rule, no matter how well principled, will ever be adopted without a non-statist revision of sovereignty in international law and country relations. As long as governments maintain economic relations regardless of each other's legitimacy, respect of internal laws and human rights, consistently with a statist recognition of their sovereignty, it will be difficult to oppose the validity of debt contracts that are entered into with similar expectations.

From an economic perspective, the idea of debt discontinuity raises a number of issues. In particular, we should ask who would benefit and, more generally, what would be the welfare effects of odious debt cancellation? There is no doubt that freeing new governments from the debt obligations of past illegitimate regimes is a worthy cause, but what matters most is preventing such regimes from taking advantage of external financing in the first place. For Cassese (1979) there is no doubt that the priority is to stop lending to odious governments. Debt write offs can help to achieve this goal because of their ex-ante implications for lending: the cancellation of debts incurred by illegitimate regimes would impose large losses on creditors and thus deter lending (unless very short term) to such regimes. The main benefit of writing off illegitimate debt, that Lienau does not realize, is to stop odious lending.

However, to be an effective threat, odious debt cancellation must be credibly enforced. This would certainly be difficult in the case the decision had to be taken ex post because of the pressures from politics, debtors and creditors. The uncertainty surrounding court decisions would also adversely affect the functioning of international financial markets. Therefore, a clear legal definition of odious debt is needed to enforce its cancellation and deter odious lending. Alternatively, as proposed by Jayachandran and Kremer (2006), an international agency or institution should be given the authority to decide/declare the odiousness, and thus the credit merit, of sovereign borrowers. Loans to odious regimes would not be prohibited but they would be sanctioned with 'no right to repayment'. A system of loan sanctions in which 'the rules of the game' are known in advance would also favor a predictable functioning of financial markets and make creditors better off by removing the uncertainty about which loans would be considered odious ex post. For instance, as many regimes turn illiberal over time, sanctions would only apply to loans made after a declaration of sovereign illegitimacy, thus allowing to

separate legitimate lending from odious debt. Certainly, Lienau places an excessive confidence in the market ability to self-regulate so that loans would carry a repudiation premium increasing in the perceived odiousness of the debt.

What characteristics would make lending illegitimate and thus prevent the accumulation of odious debt? Rethinking Sovereign Debt suggests a wide range of odious government actions that go from the violation of fundamental human rights to the absence of civil liberties, from the exercise of illegitimate power to the infringement of national laws, from corruption to an use of borrowed funds contrary to public benefit. Lienau suggests that different definitions of illegitimate debt may arise from alternative non-statist theories of sovereignty and that new customary law on debt continuity will eventually emerge from the interaction of state practice, courts' ruling, activist actions and broader international relations but she is evasive about supporting any specific proposal.

While we agree with Lineau that ex-post, with the benefit of hindsight, most cases of illegitimate debt are evident, and ruling for non-repayment would help to establish customary law, in many intermediate cases taking action is difficult in the absence of clear ex-ante definitions of illegitimate debt. As our discussion suggests, clear rules and/or loan sanctions are needed to stop lending to odious governments. In the end, the aim is not only to avoid burdening new governments with the debt of past odious regimes but preventing such regimes from receiving external financing.

What definition of odious debt should then be adopted? Distinctions based on the use of borrowed funds, say, whether for public benefit or private interests, are not useful for a number of reasons. First of all, the aim to stop or sanction illegitimate lending calls for an ex ante determination of odious debt which immediately excludes definitions based on the use of borrowed funds as the latter can only be verified ex post. There are however other reasons why outcome-oriented definitions of odious debt are unsatisfactory. In particular, the link between the borrowed funds and their uses is difficult to ascertain. Most loans, and especially bonds, are issued for deficit financing rather than targeted to specific projects. Furthermore, external resources are fungible in that, by financing needed investment, they may free resources for less noble uses. Finally, most infrastructure investments can later be used to odious ends, for example, to sustain war efforts. Financially supporting a criminal regime, even for roads, hospitals and schools, is tantamount to helping the regime's consolidation and self-preservation (Bedjaoui 1977).

If a debt can be deemed odious only in connection with the odious nature of the borrowing government, what requirements should a government satisfy to be a legitimate borrower, and be

creditworthy in the wider meaning of the term? While answering this question goes beyond the purpose of Rethinking Sovereign Debt, it is certainly a relevant issue if we want to rethink responsible lending. Conventional wisdom suggests that compliance with fundamental human rights should be a minimum requirement for sovereign borrowing, more compelling and less uncertain than democratic legitimacy or respect of internal laws. This view seems to be shared by Bedjaoui (1977): "..any loan must be considered odious, if a regime, democratically elected or not, does not respect the fundamental principles of international law such as the fundamental human rights, the sovereignty of States, or the absence of the use of force."

Debt activists have long insisted on human rights compliance as an imperative condition for responsible lending, and, interestingly, a number of private banks have adopted guidelines for socially responsible lending –the 'Equator Principles'– that, since 2013, include responsibilities for the respect of human rights.[1] It is then remarkable that international economic institutions, in tune with their member States, have shied away from human rights conditionality. This suggests that the new attention to ideas of popular sovereignty, expanded claims to self-determination and human rights are mostly rhetoric, as sovereign governments continue to refuse any interference in their internal affairs. Indeed, they have not endorsed, so far, any initiative for human rights in sovereign lending that possibly restricts their access to financial markets. This resistance is not surprising if we realize that violations of human rights via torture are more widespread than we tend to believe[2], and even less so when we consider interpretations of human rights that extend to the protection of people from arbitrary interference with their privacy and correspondence.[3] In fact, most governments are a bit odious.

[1] The Equator Principles, June 2013, are available at http://www.equator-principles.com/index.php/ep3

[2] Article 5 of the Universal Declaration of Human Rights, United Nations. According to Amnesty International (2014): "Over the past five years, Amnesty International has reported on torture and other ill-treatment in 141 countries and from every world region."

[3] Article 12 of the Universal Declaration of Human Rights, United Nations.

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