Sri Lanka: Rethinking Odious Debt

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How, to what extent, and under what conditions states should repay their debt are critical questions which resurface after every major financial crisis. Debts being legal contracts, states are bound by the principle of *pacta sunt servanda* ("agreements must be kept"). Hence, the general expectation is that all debt must be repaid, no matter the circumstances. One exception to the rule of repayment is 'odious debt.' The term broadly refers to the debts of a nation incurred against the interests of its population. Over the course of the last century, the legal doctrine of odious debt has been invoked as an argument to justify the cancellation of debts in a decolonial context (e.g. Cuba 1898, Algeria 1962) or after the fall of a despotic regime (e.g. Iraq 2003). But the odious debt doctrine has not yet found application outside these specific contexts.

The scope and application criteria of odious debt have elicited considerable interest and debate among academic and civil society circles in recent years, (Vikram and Thomas 2008) some calling for a broader and more flexible doctrine. A restated definition is indeed vital and should be welcome because most states currently burdened with crushing debt are democratic states. The reflection on the current relevance of the odious debt doctrine generates provocative questions: Are there democratic circumstances under which debt contracts should not be binding? Must it always be wartime or colonial domination to justify debt cancellations? And, under what revised definition could highly indebted countries cite the notion of odious debt?

This essay suggests that odious debt needs a restatement to stay relevant in the face of important changes affecting state (i.e. "sovereign") debt. Today, a major issue affecting creditor-debtor relations in the sovereign sector is the predicament of over-lending. Examples abound of reckless creditors pressuring vulnerable states to borrow for projects they do not need and at conditions they do not fully understand. This development, which recalls the aggressive business tactics used by predatory lenders in consumer lending, has become a ubiquitous problem affecting both developing (e.g. Puerto Rico) and developed (e.g. Greece) nations. Yet, this problem remains largely unaccounted for in international law and in the odious debt doctrine in particular. The future of odious debt depends upon a collective endeavour to make the legal doctrine more sensitive to issues of predatory lending. This essay offers insights into the benefits that such efforts may yield on states and their creditors..

Two traditions of odious debt

The starting point of almost every modern discussion of odious debt is the work of the Russian lawyer Alexander Sack. Unfortunately, Sack's treatise is couched in general and ambiguous terms so much that the meaning and scope of odious debt still remains a contested issue among lawyers and legal historians. According to a traditional reading of Sack, (King 2016) debts are odious and should not be repaid when they were incurred by *irregular regimes* and for *improper uses*. In this view, there is no ground to invoke odious debt if there is not a despot or a colonial empire at the center of the story. A powerful alternative opinion is provided by Ludington *et al.* and Toussaint, (Ludington et al. 2017) arguing that Sack was not, or at least not primarily, concerned with the nature (democratic or despotic) of the government, but focused on *improper* uses of debts and *creditor complicity* (whether creditors knew about the likely misuse of the funds they were advancing).

This exercise of legal exegesis may very well produce no clear winners, for there is not just one but several acceptable definitions of odious debt depending on the context of application. The traditional interpretation was pertinent as long as there were populations to liberate from odious loans incurred by undemocratic authorities. Such debts being used to oppress the people, it was immoral to ask oppressed populations to repay the debt. Of course, this interpretation remains relevant and appropriate. The current context in Venezuela is a case in point (*The Financial Times* 2017). But it is also hard not to notice that colonial governance has all but disappeared today (at least formally) and that loans to dictatorships take up only a narrow corner of the $22 trillion worth of sovereign bonds outstanding in 2018. Now that most sovereign debts are contracted by democratic states, odious debt, at least in its traditional variant, runs the risk of becoming a legal doctrine without any clear use. As such, and without prejudice to the historical investigation of what Sack actually wrote, the alternative interpretation is more appealing and desirable. The two criteria of debt misuses and creditor complicity allow for the representation of key problems facing democratic states, in particular their vulnerability to predatory lending. Now that the broad context of odious debt has been established, it is time to address the problem of predatory lending.

Over-borrowing or over-lending?

Perhaps the most controversial aspect of current sovereign debt regime is what we take for granted, namely that the function of creditors is to furnish capital to states, for projects they need. When roles are distributed in this way, states must signal to creditors that they have the capacity and willingness to repay, for instance by obtaining a AAA credit rating (Lemoine 2016). But such approach of creditor-debtor interaction gives only a partial understanding of what occurs in the real world of debt. Lenders are not simply 'on demand,' passively waiting to subscribe to bond issuances. Instead, creditors often engage in active lobbying to convince officials to borrow for projects they do not need. Recall, for instance, the famous story of the Bavarian town in need of $125,000 to build a power station but that ended up with a $3 million loan after repeated persuasion from the agents of a Wall Street bank (Winkler 1933). This case, among others, reminds us that lenders are not just about furnishing credit for needs, they are about creating those needs.

The problem of over-borrowing has been a major cause of financial uncertainty since the 1980s. Of course, states do not always make decisions that are in their best interests. Politicians often make opportunistic uses of foreign credit to buy electoral favours. But such emphasis on domestic factors like the electoral cycle diverts attention away from structural factors on the lending side. In 1976, International Monetary Fund (IMF) managing director Johannes Witteveen worried that creditor activism would lead developing countries to take on debts beyond the range of what is reasonable: "commercial banks should not be so easily available that […] it caused the authorities to accumulate larger debts than were desirable" (James 2002). This statement was prophetic. We find a recurring pattern from Latin America and Southeast Asia in the 1980s-1990s to Europe in the 2000s: each time the volume of foreign credit invested was too much for these economies to handle, causing these countries to experience difficulties in debt repayment. One lesson of financial history is that increasing borrowing is as much about states' profligate behaviour than it is about creditors' profit-driven motivations to over-lend. Greece is a paradigmatic case.

The odious lending cycle: Greek debt revisited

Greece's borrowing over the past two decades can be understood as a classic case of predatory lending. In the context of this essay, predatory lending is defined as the practice of a lender deceptively convincing a state to borrow for projects it does not need and at unfair or abusive terms.

The cycle of odious lending comes down to three consecutive stages (*creditor activism* followed by *creative accounting* followed by *predatory bailouts*), each stage contributing to increase borrowing beyond a nation's capacity to repay.

The first stage involved large European companies persuading Greece to borrow for projects she did not need. After the return of democracy in the 1970s, the value of Greek military imports per head of population became the second largest in the world. French and German firms were the main beneficiaries of Greece's spending spree. In 2000, the French firm Dassault sold Mirage jets and air missiles for €10 billion. In 2003, the German manufacturer Krauss Maffei Wegmann signed a lucrative contract of sale for 170 Leopard tanks (€1.6 billion). Perhaps the most infamous case was the €5 billion submarine contract that Greece signed in 2000 with ThyssenKrupp (*The New York Times* 2014). In 2015, Greece's former defence minister was jailed for accepting €8 million in bribes from one of the German companies involved in the deal. For decades, arms purchases were the greatest contributing factor to Greece's soaring debt. Had Greece kept defence spending to levels similar to other European states, it would have saved around €150 billion, a sum well in excess of the first 2010 bailout. This business did not stop after the crisis. In 2010, France delivered six frigates and combat helicopters for a price tag of over €3 billion and this in spite of the harsh policies of austerity implemented to reduce Greece's already huge debt.

The second stage in the cycle of predatory lending involved the use of creative accounting techniques to hide Greece's public debt and keep the country in the lending game. In 2001, Goldman Sachs offered its services to transact a €2.8 billion cross-currency swap on behalf of Greece. The purpose of the transaction was to disguise Greece's outstanding debts and help her meet the deficit target for entering the Eurozone (*The Independent* 2015). The bank received €600 million for its services. But Greek officials would realise too late that the deal which initially looked so attractive was in reality very risky. Greece ended up owing over €5 billion because of the complex rate formula Goldman used to engineer the deal.

Accounting wizardry looms large in the chain of causal mechanisms that led to Greece's insolvency 10 years later. Removing debts from Greece's balance-sheet gave a rosy picture on Greek finances that misled investors and paved the way for a decade-long spending spree. In the early 2000s, financial analysts congratulated Greece as the financial 'powerhouse' of southern Europe. Driven by profit motives, investors did not see the purpose of exercising due diligence when examining the credit profile of Greece. When accounting fraud was revealed in late 2009, and as the country entered into the debt crisis, some observers called for the restructuration of Greek debt under the rationale that responsibility for unpaid debt should be shared between the irresponsible borrowers and the reckless lenders (*The Guardian* 2012). But quite the opposite happened. When it became clear that Greece had taken on too much debt, public institutions were called to the rescue. Mass lending continued unabated: only the identity of the lender (from private to public) changed.

In May 2010, the Troika (the IMF, European Commission and European Central Bank) loaned €110 billion in exchange of Greece's pledge to implement drastic austerity policies. Troika's bailouts can be characterised as the continuation of predatory lending by other means: Greece was forced to borrow more to repay the debt incurred on behalf of private creditors. The Troika added more debt to debt and this in spite of the IMF's rule not to lend to insolvent countries. Before making rescue loans, the IMF is normally entitled to request debt relief in order to restore the solvency of crippled countries. Instead, it granted massive sums to Greece despite knowledge of her impossibility to repay. Studies have evidenced that IMF experts clearly perceived that Greek debt was unsustainable and that the country would not be able to grow out of its debt (Penet 2018) "They have criminal responsibility," Nobel laureate Joseph Stiglitz said of the Troika that loaned Greece massive funds to repay French and German banks holding over 40% of Greek debt (*The Time* 2015).

As is well known, Troika loans have produced disastrous results for Greece. The lending program has depressed the economy, increased public debt, sent dozens of thousands of Greeks searching for a job abroad and provoked a domestic health crisis. Today, Greece's debt burden continues to remain unsustainable, some 10 years after the first Troika loans were made. The portion of Greek debt that originated out of predatory lending is hard to assess with a degree of certainty. If not all debts are odious and therefore should be cancelled, the Goldman Sachs transaction of 2001 and the IMF loan were odious in the sense that creditors knew very well that loans would depress the economy and harm the population.

Beyond Greece: systemic deception and manipulation in sovereign debt lending

The cycle of predatory lending is by no means restricted to Greece. In fact, many other democratic states have also faced the adverse consequences of reckless lending. Creditor activism in the sovereign sector (the 1st stage in the odious lending cycle) recalls the door-to-door solicitations of predatory lenders in the consumer lending industry. This development is not new as there is considerable historical precedence of bankers turned into 'banksters' exploiting information asymmetries to over-lend and rack up hefty commissions (Flandreau *et al* 2010). Creative accounting is also a pervasive problem in municipal lending. In the U.S. many cities and counties were persuaded to buy interest-rate swaps to the tune of hundreds of billions of dollars. In France, the bank Dexia deceived the officials of many large cities with toxic loans (Thomas 2013). At last, the Irish rescue package of 2011 is yet another example of predatory bailouts granted to cover up for the losses incurred by private banks. In 2011, Troika loans transited through the Irish government to repay the senior bondholders of Ireland's main credit institutions. The Irish people were thus forced to handle the bill for risky investments that profited the banking industry, whose role was critical in fuelling the Irish housing bubble.

The current debt regime encourages manipulation and deception. Of course, states bear responsibility for their financial plight. Fiscal profligacy and tax evasion were important problems in Greece. But debt contracts being voluntary agreements, overborrowing could not exist without lenders' acceptance. Lenders are to blame as much as borrowers: banks wilfully encouraged Greece to take on massive amounts of debt, sometimes resorting to salesmen techniques destined to lure the less financially literate consumers. Unregulated lending is more often than not a decisive factor leading to unsustainable debts: lenders typically escape scrutiny and are not held to any principle of restraint when lending to states. Too often creditors make reckless loans knowing that debts will be bailed out further down the road. Under such circumstances, prudential behaviour is no longer rewarded and safety is no longer the foundation of the lending business. For states, irresponsible lending practices are conducive to over-borrowing and considerable hardship on the population.

Now is a good time to return to Sack: should states repay their debts when they were contracted under predatory terms, for purposes contradictory to the public interest and with creditors' complicity? In the following section, I show that the predicament of predatory lending stands a good chance of finding representation under existing law. The principle of responsible lending is recognised in the private (domestic) law of many European and international states.

Towards principles of responsible lending

In the panorama of possible options, the municipal law of New York and England, the world's main financial centres, afford states with at least two lines of defence against predatory lenders. Under the legal concept of 'abuse of rights,' states may find protection against corruption debts, i.e. debts contracted through bribery or corruption of a state representative for her personal enrichment. If the lender has committed fraud, debts are contracted under abuse of rights and the borrowing state can invoke the nullity of the contract and avoid the repayment of the debt. The second one is the ‘law of agency’ which imposes a fiduciary obligation on the agent to act loyally in the interests of the principal. If the lender provides money to a state, knowing or having reason to be suspicious of the fact that the debt exceeds the state’s capacity to repay and will be harmful to the population, legal principles seem to indicate that she has to bear some responsibility. These concepts provide that lenders should not be completely disconnected from the results of their loans. When a loan caused damages and if those damages were foreseeable, these laws suggest that lenders could be held liable in municipal courts. This is evidence to suggest that the notion of responsible lending is now sufficiently widespread to emerge as a judicial custom.

It remains that holding lenders responsible for their bad investments can be exceptionally difficult. Making bad investments is not enough to trigger legal responsibility. For there to be a ground for non-repayment, there must be some kind of evidence that creditors purposefully deceived the entity contracting debt. International organisations have a key role in the effort to codify the scope and meaning of creditor responsibility. The United Nations Conference on Trade and Development (UNCTAD) published in 2012 the *Principles on Promoting Responsible Sovereign Lending and Borrowing* with a section on the “Responsibility of lenders.” This initiative is a step in the right direction. Unfortunately, not much can be achieved without the IMF. The IMF has a key role to play because its loans have frequently been used to rescue reckless leaders instead of fiscally strapped nations. By adding debts to debts, IMF loans often result in significant damages to the economy and considerable harm to the population. A significant achievement would entail the IMF making the assessment of the predatory nature of loans a pre-existing condition to financial assistance. IMF funds disbursement are already conditioned to several rules, the main one being an assessment of the debt sustainability. These rules should be amended to include background check in the view of excluding reckless creditors from benefitting of IMF funds. Too often lenders feel safe to lend as much as they can to states knowing they will be bailed out with IMF funds. Under such circumstances, lenders are insulated from the consequences of their action and creditor activism becomes virtually risk-free.

Solutions arising from the municipal law and the IMF would be forthcoming to important changes in lending practices. Both initiatives could shape creditor behaviour away from reckless lending. Faced with the threat of debt repudiation, the lender would stand to lose the one thing it cares most about, its money. This is altogether healthy as it would contribute to clean up investors’ behaviour and create the sort of incentives not to over-lend that creditors would incorporate int their lending equation. The point is not to wish to see banks lurching toward the courthouse but rather to make investors more prudent and prevent reckless lending before it occurs. Seen this way, avowing odious debt would be part of the duty of care that lenders must exercise to avoid financial losses.

Why less lending might be a good thing after all

The proposed solutions would give creditors a more stable relationship with countries but they are also forthcoming to a reduction of international lending. International capital flows are not necessarily a good thing. Prominent economists have proposed to reinternalise debt financing to reduce the dependence on foreign-financed deficits and create incentives for states to borrow more parsimoniously (Reinhart and Trebesch 2015). Additionally, with less foreign credit to rely on, states would operate under stronger fiscal pressures to reign in tax evasion and reform bureaucratic clientelism. In Greece, weak tax collection was left unattended because the government compensated the lost revenues with cheap international credit.

Concerns over odious lending is in the best interest for both creditors and borrowers. As suggested above, honest creditors were among the victims of deceptive lending practices. In Greece, the falsification of key data points by Goldman Sachs skewed the perspective of honest lenders on Greek solvency. By making Greece solvent while it was not, Goldman’ deceptive scheme misled markets and lured the investment community into investing in Greek bonds without knowing the full extent of the reality of Greek debt.

Conclusion

I have suggested that the doctrine of odious debt should be articulated more clearly with the issue of predatory lending. To stay relevant in the current context, where most sovereign debts are contracted by democratic states, the doctrine of odious debt should be restated to become a legal protection against odious lenders.

As I have shown, laws already exist to regulate predatory lending and hold lenders accountable. If municipal (private) law provides a sound basis for curbing predatory lending, then why do we need a doctrine of odious debt after all? Lawyers have suggested that the principles of fair and responsible lending can be more effectively pursued outside the doctrine of odious debt. Additionally, there continues to be a great deal of scepticism among lawyers about whether odious debt can find recognition in international customary law (Buchheit et al 2007).

For lawyers, the value of odious debt is a function of its legal enforceability. This legalistic position fails to acknowledge that the doctrine may not need to be recognised by courts to find concrete political application. Odious debt is a powerful label that carries legal as well as symbolic meaning. As such, it is more consequential on policy than we might think from looking at critics formulated by legal scholars. History has shown repeatedly that a legal doctrine does not need to be recognised in international law to bear real world effects. For instance, in 2003 the Bush administration in rare harmony with civil society groups claimed that Iraq's debt might be regarded as odious and should not be repaid. This rather loose invocation of odious debt was a strong factor in the subsequent decision to cancel Iraqi debt. Thus, a legal doctrine can be invoked outside the courtroom to articulate soft policy uses, beyond any considerations of analytical validity and internal specification. Ultimately, the great strength of odious debt is to serve as a hook on which to hang a political claim about debt cancellation.

Today, the label of odious debt remains immensely useful on condition that the odious label applies to reckless lenders and not just to irregular states. Bridging the two realities of odious debt and predatory lending is a key aspect in future debt disputes. Venezuela and Greece will be two important test cases for the implementation of the traditional and restated definition of odious debt.

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