

## **FAIRNESS IN SOVEREIGN DEBT<sup>\*</sup>**

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WHEN CAN WE SAY that a debt crisis has been resolved fairly? That is, what makes processes of debt restructuring, debt cancellation, or the enforcement of debt contracts more or less fair, or the outcomes of such processes better or worse? These are not idle questions. The recent economic collapse in Argentina and financial crisis in Turkey, and the persistent unsustainable debt burdens of many developing countries highlight the practically urgent problem of excessive indebtedness. High debt levels can limit a sovereign government's capacity to provide social services necessary for the well-being of its citizens, and divert resources and energy from the pursuit of long-term development strategies. In addition, after a government defaults, the mechanisms for managing the restructuring of sovereign debt usually act slowly, do not return the country to debt sustainability, and often leave the different classes of creditors as well as the people of the indebted country feeling as if they have been treated unfairly. This in turn can create disincentives for lending and investment that can be crucial to the prospects of developed and developing countries alike. An often overlooked but very important effect of financial crises and the debts that often engender them is that they can lead the crisis countries to increased dependence on international institutions and the policy conditionality they require in return for their continued support, limiting their capabilities and those of their citizens to exercise meaningful control over their policies and institutions.

These outcomes have been viewed by many not merely as extremely *unfortunate* and *regrettable*, but also as deeply *unfair*. And indeed, increasingly potent popular movements have pressured governments, financial institutions, and the financial community to seek what they take to be fairer solutions to debt crises. Some of these resulting initiatives, including that for the Heavily Indebted Poor Countries (HIPC), have focused on defining sustainable debt levels for poor countries and designing policies to maintain debt at these levels. Other proposals, such as the Fair and Transparent Arbitration Process, which mimic at the global level the legal bankruptcy regimes under national law (albeit without the same enforcement authority), have sought means of distinguishing between debts for which creditors deserve full repayment from those for which creditors either lack claims or have claims that are too weak to recover what they have lent (see Raffer 1990, Afrodad 2001, Erlassjahr 2001). Still others have instead recommended a contractual approach to sovereign debt crises, in which new clauses are introduced into bond contracts to enable debts to be restructured more easily and quickly (see EMTA 2003; Porzecanski 2003; Group of Ten 2002).

The merits of these programs and proposals for dealing more fairly with sovereign debt remain hotly disputed. In this essay, we try to take a step back from the political fray and examine some more fundamental considerations that seem relevant to assessing the fairness of current arrangements governing economic exchanges related to debt contracts and alternatives that have been (or might be) proposed to them.

Our discussion is organized into seven sections. First, we characterize briefly the concept of fairness and its role in social evaluation. Second, we clarify what sovereign debt is, and, third, the ethical statuses that particular sovereign debts can have. Fourth, we identify and describe the main features of current practices related to sovereign debt. Fifth, we describe an “ideal picture” of creditor/debtor relations. We argue that in such a scenario a broad range of ethical considerations can plausibly be invoked in support of practices that closely resemble those presently governing sovereign debt. Sixth, we draw attention to the many ways in which in reality the relations between sovereign debtors and their creditors differ markedly from the relationships between the creditor and debtor in the ideal picture. Because of this, many of the ethical considerations that would support present practices were relations between sovereign debtors and their creditors to resemble more closely those depicted in the ideal picture fail to do so under present circumstances. We conclude, moreover, that the remaining ethical considerations that might be advanced in support of the present system are at best quite inconclusive. Finally, we describe briefly specific reform proposals to current practices. While we will not attempt to show that these proposals would necessarily make the rules governing economic exchanges relevant to sovereign debt more fair, we conclude, in light of our earlier analysis, that they must be given much more serious consideration than they have so far received in policy circles. Indeed, there are strong *prima facie* reasons to believe that some combination of these proposed policies might prevent or mitigate some of the most ethically regrettable outcomes of present practices and norms by changing the incentives of sovereign borrowers and those who lend to them.

### **I. The Concept of Fairness**

Fairness and unfairness are *core* ethical predicates, which are broad in applications, complex in structure, and morally deep in content. They are *broad in application*, since many different kinds of things are said to be fair or unfair. We speak variously of persons *being* unfair, for example, when they typically fail to consider the feelings of others. We refer to the conduct of agents (persons, firms, governments, etc.) as *treating* others unfairly—such when these agents fail to deal with others evenhandedly or show them respect. We also sometimes claim that social institutions *affect* or *treat* agents or groups unfairly—for example, when they include rules that allocate scarce resources or valued occupations and positions of authority on the basis of such apparently ethically arbitrary characteristics as race, gender, or religious affiliation. Finally, we judge outcomes—such as the fact that some people are much worse off than others through no fault of their own, or perhaps that people whose conduct toward others is fair suffer terrible misfortunes while others who conduct themselves unfairly enjoy good fortune—as unfair.

The concepts of fairness and unfairness are *complex in structure*. Social institutions, such as laws governing what kinds of things can be owned, how they can be acquired, transferred, relinquished, and forfeited, the manner in which decisions concerning trade policy and the monetary system are made, and so on, can be judged to be *distributively* unfair—perhaps because they leave many badly off and a

few very well off; *procedurally* unfair—perhaps because they systematically disadvantage some in economic competition; or *metaprocedurally* unfair—perhaps because these arrangements were first fixed when many who should have had some say in their content were excluded from voting or other forms of political participation.

The concepts of fairness and unfairness are also *morally deep* in content. To call an institution unfair is to claim that there are strong reasons to reform it, and to claim that a person is treating another unfairly is to claim that they have strong reasons to alter their conduct. Indeed, unlike reasons to act charitably, beneficently, or kindly, reasons based on fairness are usually taken to state quite stringent ethical requirements. This is perhaps particularly true with respect to the ethical assessment of social institutions. Reasons based on fairness to reform some social rule, such as electoral procedures that exclude many competent adults within a country from voting for political representatives, for example, are generally taken to be not only stringent but *decisive* unless undertaking such reforms will likely bring about still greater unfairness elsewhere in the social system.<sup>1</sup> More controversially, it has been argued that particular individuals may sometimes lack decisive reasons to work for the reform of an unfair institution when doing so will require of them significant personal sacrifice, or when they have not themselves contributed substantially to its unfairness.

Discussions of fairness with respect to sovereign debt relate mainly to two topics: (1) the conduct of sovereigns and other agents involved in borrowing and lending financial resources; and (2) rules governing the borrowing and lending of financial resources between sovereigns and other agents.

Topic (1) involves the assessment of various actors involved in sovereign borrowing and lending, and the specification of the ethical norms that should guide their contractual behavior, such as whether lenders should be more discriminating about the sovereigns to whom they should provide resources, and whether sovereigns ought to have made sounder borrowing decisions, been more honest in their dealings with creditors (and their own people), or acted more fairly in their decisions regarding domestic budgetary expenditures. Topic (2) relates to the assessment of rules that govern economic exchanges relevant to the practice of sovereign borrowing, and the ethical norms that should guide actors in designing them. These rules include those governing the kinds of contracts that sovereign borrowers and creditors are permitted to enter; the circumstances under which

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<sup>1</sup> That considerations of fairness seem to play such a foundational role, especially with respect to the assessment of social institutions, raises the question of whether and how this concept differs from the concept of justice (crisply characterized in Pogge 2001b, to which the present discussion is indebted). While we are unsure whether and how the meaning of these concepts differs, we are skeptical that the truth or (if you are inclined to moral anti-realism) assertability conditions of sentences in which the predicates fair and unfair, or just and unjust respectively, differ or differ fundamentally. Does it make sense to say that a social institution, for example, was unjust but that it was fair or that it was fair but unjust?

contracts entered into are to be considered legitimate; the conditions (if any) under which legitimate contracts of sovereign borrowers should no longer be considered to bind them to repay their creditors on the terms stipulated in them; and those determining the steps that creditors and others are permitted to take in order to enforce contracts that are considered to bind sovereign debtors (including informal practices, such as debt workouts).<sup>2</sup>

In the remainder of this essay we will emphasize topic (2). This is not because topic (1) is irrelevant or less important. Surely the conduct of agents involved in lending and borrowing *is* quite relevant to many of the regrettable features of the current situation. There is little doubt that were creditors to act (and to have acted) in their lending decisions less recklessly and with more regard to the harms their conduct imposes on others, and if sovereigns had made sounder borrowing decisions and used the resources acquired through these borrowings in a way that was more beneficial to their general population, the outcomes of present practices would be much better.

Indeed, it is partly because of the clear interconnections between these topics that we will emphasize topic (2). Determining whether the rules governing economic exchanges relevant to sovereign debt are unfair and developing a more informed view of what alternative arrangements might be fairer will enable us to provide a fuller ethical assessment of the actors involved in sovereign debt, since it is they who institute, benefit from, uphold, or contrarily seek to reform existing rules. For example, however decently a lender may conduct themselves in their direct dealings with sovereigns—for example, avoiding loans to notably corrupt regimes that are unlikely to use resources to benefit their people—our overall ethical assessment of their conduct may not be particularly positive if they are actively engaged in lobbying their governments to support rules governing debt workouts that seem on balance to treat sovereign debtors unfairly. Furthermore, our assessment of whether the rules governing economic interaction relevant to sovereign debt are fair will significantly influence even our *descriptions* of the interactions among different agents involved in borrowing and lending. Whether, for example, it is deemed to be a legitimate expression of national self-determination when the central bank of a country raises interest rates unilaterally, even when this harms the economic prospects of other countries, or is instead thought to exclude illegitimately those who can be significantly affected by political decisions from exercising some degree of influence over them, will significantly influence our assessment of the responsibilities of developing countries and the United States with respect to the 1980s debt crisis. If we affirm that such policies were indeed a legitimate expression of national self-determination, then the United States' having undertaken it will be considered as part of the background circumstances that developing countries ought to have taken into account in deciding whether and on what terms to borrow (see Miller 2004, Cappelen 2005). If, on the other hand, such policies are

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<sup>2</sup> In this essay, by “contracts” we understand broadly any binding agreement, which includes both formal/legal contracts and informal/nonlegal practices that are customary when dealing with sovereign debts.

judged to have been illegitimately undertaken because they were procedurally or metaprocedurally unfair, then the claims of the United States (and perhaps other creditors) to amounts lent to developing countries may reasonably be viewed as weakened due to the fact that they have unfairly and significantly harmed the economic prospects of these borrowers through their domestic policies (Pogge 2001a, Reddy 2005). Indeed, if such decisions are deemed to have been illegitimately undertaken, these claims may be viewed as weakened even if evidence that such policies did cause such harm is inconclusive (Barry 2005).

## **II. The Meaning of Sovereign Debt**

What is sovereign debt? To answer this question, we need to have a clear idea of what sovereigns are and what debt is. It is widely recognized that the idea of sovereignty (and thus of a sovereign) is contestable (Philpott 2003; Krasner 1999). That the question of what debt consists in is also much more complex than may at first appear, however, is not often noted. It might be argued that A owes a debt to B when B has provided some benefit to A and has asserted a claim to repayment. This obviously won't do, however, since the mere fact that B claims that A owes it repayment for something does not show that A is indebted to B. Indeed, people make false and spurious claims all the time and it would be misleading to suggest that rejecting such claims amounts to "debt relief" or that by withdrawing them a creditor has thereby "reduced its claims" on a "debtor." It is more natural in such cases to claim that there *were no debts to begin with*, only invalid claims that have been rightly rejected. It may therefore be appropriate to define debt in terms of *ethically* valid claims. That is, A owes a debt to B only if B has a valid moral claim to repayment from A. This *moralized* understanding of debt has many things to recommend it. Indeed, speaking of "debt relief" and "voluntary" reduction of "claims" suggests, often misleadingly, that the creditors involved had morally valid claims to repayment and are therefore offering "assistance" to poor countries—to which they can attach whatever conditions they like. What is at issue, it may be argued, is whether these countries really have such debts in the first place, and not the conditions under which they should be "forgiven," since speaking in terms of "forgiveness" essentially assumes the validity of the creditor's claims.

While we are in sympathy with this account and believe that the concerns it expresses are very important, we fear that it may cause some confusion in evaluating the current debate on sovereign debt, which has been framed (for better or worse) in terms of the conditions under which (and terms on which) debts should be repaid. For this reason, we will understand the concept of debt in terms of the following definition:

A owes a debt to B if and only if:

- (1) B has lent resources to A; and,
- (2) B has a claim to repayment from A that has at least prima facie legal validity.

We will assume, moreover, that it makes sense to distinguish between legally valid and ethically valid claims. That is, while determinations of legal validity may depend in part on ethical considerations (as argued in Dworkin 1977, 1985), and while the fact that one has a legally valid claim may be seen as an important ethical consideration in determining whether one should be repaid, there are many contexts in which those who have legally valid claims to repayment lack ethically valid claims to repayment and in which those who lack legally valid obligations to repay nevertheless have ethically valid obligations to repay. Conflicts between legally valid and ethically valid claims and obligations will be most pronounced when legal systems are unjust or when they contain many “gaps,” but it is unlikely that such conflicts can ever be completely removed.

### III. The Ethical Status of Debts

We can distinguish between the ethical statuses of different types of debt. At the first level, a distinction can be drawn between those debts for which the debtor:

- (a) has an ethical obligation to repay; and,
- (b) has no ethical obligation to repay.

When an agent has an obligation to do something, this provides her with a reason to do it. However, obligations to do something do not necessarily provide decisive or under some circumstances even particularly weighty reasons to do it (Raz 1986, Thomson 1990). One may sometimes have conclusive reason not to honor one’s obligations, such as when one fails to show up for an important professional meeting because of a family emergency. Even in cases where one does the ethically correct thing by failing to honor one’s obligations, obligations matter, since one typically must make efforts to compensate those to whom one has failed to honor them (Thomson 1990). Having missed the meeting, I must be willing to take pains to reschedule it (if possible) in a way that is convenient for others. Among those debts that the debtor is ethically obliged to repay, we can therefore distinguish between:

- (i) debts that the agent *ought* to repay;
- (ii) debts that the debtor may *permissibly* repay or not repay; and,
- (iii) debts that the agent nevertheless *ought not* to repay.

Finally, it may be that one ought to repay debts even when she is not ethically obliged to do so, such as when failing to repay an invalid debt will hurt her credit rating and thus diminish opportunities for future borrowing that is essential to the economic prospects of her family. Among those debts for which the debtor is not ethically obliged to repay, a distinction can therefore also be drawn between:

- (i) debts that the debtor *ought* still repay;
- (ii) debts that the debtor may *permissibly* pay or not pay; and,
- (iii) debts that the debtor *ought not to repay*.

We can also distinguish between debts in terms of the attitudes that *creditors* ought to take toward them. I may have a valid claim that my employee repays a small loan that I have extended to him, but nevertheless do the right thing by forgiving it if he can repay it only at great sacrifice and I will in no way suffer from his nonperformance. We sometimes have “a right to do wrong” (as put by Waldron 1981). Among those debts that the debtor is obliged to repay, a distinction can therefore be drawn between:

- (i) debts for which the owner of the debt *ought* (in part or entirely) *not to demand* repayment (and thus to “forgive”);
- (ii) debts for which the owner of the debt *may permissibly demand* or *not demand* repayment; and,
- (iii) debts for which the owner of the debt *ought to demand* repayment.

Among those debts that the debtor is not obliged to repay, we can similarly distinguish between:

- (i) debts for which the owner of the debt *ought not to demand* repayment;
- (ii) debts for which the owner of the debt *may permissibly demand* repayment; and,
- (iii) debts for which the owner of the debt *ought to demand* repayment.

These last two possibilities ((ii) and (iii)) may seem odd, but they are not difficult to imagine, especially in the context of debts incurred by collective agents such as governments. We may think, for example, that country A has no obligation to repay a debt to country B because the debt was incurred by a murderous military dictatorship that used its resources to repress and impoverish the population. Suppose, however, that although this dictatorship is no longer in power it has been replaced by a corrupt and wasteful regime that consistently misallocates public funds in harmful ways. A creditor country may plausibly demand repayment from such a regime if it has strong reason to believe that these resources would do more harm than good if left in the regime’s hands, especially if they use these funds to lessen the suffering of the debtor countries residents or that of unjustly impoverished persons.

**Table 1. Ethical statuses of different kinds of debt.**

	<i>Debtor has ethical obligation to repay</i>			<i>Debtor has no ethical obligation to repay</i>		
<i>Debtor</i>	Ought to repay	May permissibly demand repayment	Ought not to repay	Ought to repay	May permissibly repay	Ought not to repay
<i>Creditor</i>	Ought to demand repayment	May permissibly demand repayment	Ought to forgive	Ought to demand repayment	May demand repayment	Ought not to demand repayment



Finally, one can distinguish between the ethical status of a debt, and the ethical status of *particular claims regarding the terms* on which the debtor is obliged to repay it.

It may be tempting to think that this distinction is not really important. After all, when a debt contract is made, it typically stipulates the schedule on which it is to be repaid. Insofar as there is an ethically valid claim to repayment of the debt at all, it might be argued, there ought to be an ethically valid claim to repayment on the terms under which it was incurred. This seems intuitively implausible, however. Suppose that I freely borrow resources from A on terms that I repay him in monthly installments over the course of the following year. Due to an accident, however, I find myself unable to work for a period of six months, after which I will resume earning a salary at the same level. If during the period of incapacitation I stick with the payment schedule stipulated in the initial agreement, I will be unable to afford physical therapy and pay for other basic necessities, which will raise the risk that I will never be sufficiently rehabilitated to resume work. It seems plausible to claim that the mere fact of my injury does not shield me from A's claim to repayment. Indeed, if it remains much more difficult than anticipated to repay A even after I resume full-time work, it may nevertheless plausibly be maintained that I am obliged to repay the full amount. However, it seems less plausible to claim that I am obliged to repay according to the original schedule.<sup>3</sup>

These considerations are relevant for evaluating issues that frequently arise in the debt context. When some agent is unable to keep up with payments or can only do so at unacceptable sacrifice, they are typically expected at least to continue to pay the interest owed on the principal. This means that, insofar as they are unable to pay according to schedule, the entire amount of the debt will grow. The claim of the lender to "full" repayment thus becomes ambiguous, since it can refer to the principal (plus the interest attached to each monthly payment as stipulated in the original agreement) or it can refer to the principal, interest on monthly payments stipulated in the original agreement, and any additional interest payments that arise because the debtor does not meet their monthly obligations. If we believe that there are compelling reasons to diverge from the stipulated payment schedule even while honoring the obligation to repay the principal, then we may hold that creditors lack claims to the additional interest that might otherwise be thought to be owed to them if the debtor is unable to meet their monthly payments.

The reasons for modifying the terms on which claims can be repaid may seem much more decisive when, unlike our simple example, the lender's behavior unfairly and adversely affects the debtor in a way that makes it much more difficult for the debtor to meet their obligations as stipulated in the contract.

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<sup>3</sup> It is also important to note that even if we do hold that I am obliged to repay on the original schedule, and that the creditor may permissibly demand repayment in full, we may not feel that he may permissibly demand repayment on the original schedule. If the cost to him of allowing greater flexibility in repayment terms is slight, we may think that he acts very wrongly if he nevertheless insists on the original schedule.

The discussion so far has identified the ethical statuses that debts may have, but has provided relatively little guidance about how to determine which status particular debts have or the fairness of rules governing economic exchanges relevant to sovereign debt. We have merely provided categories without indicating which kinds of considerations are relevant for determining *which debts fall into which category*. Next, we examine issues that are relevant to this task.

#### **IV. The Central Features of the Current Practice**

Sovereign contracts are entered, on the borrower side, by national governments (“sovereign debtors”) and, on the lender side, by national governments (“official/bilateral creditors”), international financial institutions, such as the IMF, World Bank, or regional development banks (“multilateral creditors”), or bondholders (“private creditors”).<sup>4</sup>

##### *Internal and External Sovereignty*

When a finance minister or other public official makes the decision to borrow money in the name of the government, the debts they incur are recognized and treated as an obligation of the country as a whole, which in turn raises revenues to service its debt (at least in part) from taxes imposed on citizens and other subjects taxable by the government (for a more detailed discussion, see Herman 2005). When a new government comes to power, all of the debts that were obligations of the previous regime are treated as the new government’s. Indeed, this is true even in cases of state succession and dissolution, as specified in the 1983 Vienna Convention on State Succession in Respect of Property, Archives and Debts. Since the debt is serviced primarily from tax revenues, the present and future citizens (and other subjects taxable by the borrowing government) are therefore held liable to repay it. Such ministers or public officials (and the government more generally) thus enjoy not only *internal sovereignty*—unique power and authority within their state—but also *external sovereignty*—unique power to alter the claims of others on their present and future citizens and residents, and thus the privileges of these citizens and residents with respect to them (the terminology of powers, claims, and privileges is drawn from Hohfeld 1919; we owe the terms “internal” and “external sovereignty” to Thomas Pogge). Governments have nearly unlimited privileges in

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<sup>4</sup> Until the early 1980s, private lending constituted credit extended by commercial bank syndicates, but virtually all of their claims have been passed on in the bond market. Though debtors are formally treated as a uniform class, we can distinguish among them in terms of the kind of credit to which they have access. For example, countries with low per capita income and undeveloped but resource-rich economies (such as Nigeria) will have some ability to sell bonds in international markets (because it is an oil producer), as well as access to multilateral lenders that lend on concessional terms such as the International Development Association, the concessional lending arm of the World Bank (because it is poor), and to official lenders (because of its strategic importance). In contrast, countries with low per capita income and undeveloped and resource-poor economies will generally only have access to multilateral lenders. Middle-income countries with emerging markets generally have some access to all three types of creditors (though to what extent depends on their particular levels of income per capita for multilateral lenders, their creditworthiness for private lenders, and on their perceived significance for official creditors).

what they may legally borrow, although of course creditors are at liberty not to extend credit to them.

### *Unlimited Lending Privileges*

Corollary to the external sovereignty of governments to borrow, creditors have the unlimited privilege to lend to whichever sovereign regimes they wish, in whatever amounts they deem fit, and on whatever terms they consider desirable. Their claims against the countries that have borrowed from them are in no way affected by either the nature of the political organization of the country to which they lend, the circumstances that it confronts, or the uses to which it puts the borrowed resources.

### *Three Features of Sovereign Debt Contracts*

At present, debt contracts that are formed between sovereign borrowers and their creditors have three main features. First, they are *rigid*: debt is to be paid according to regular schedules, without consideration of changing circumstances of the creditor or debtor or of the environment in which they interact. Second, they are *neutral*: what sovereign borrowers choose to do with the resources they borrow has no effect on the claims of creditors upon them (and thus also the claims that they have on their citizens and other tax subjects). Third, they are *extensive*: no present or future citizen or tax subject of the debtor country is shielded from obligations to repay debts.

### *Pacta Sunt Servanda*

*Pacta sunt servanda*, or “pacts must be respected,” is the basic norm that underlies the present treatment of sovereign debt contracts. When a sovereign borrower defaults, it is treated as being in breach of contract and under obligation to repay the full amount of the loan, along with any interest that the contract stipulates must be added to the principal under such conditions. Unless a creditor decides to “forgive” a debt, then they retain full rights to claim it. There is no forum in which a debtor can bring a claim that their obligations under the contract should be considered invalid, or that they may permissibly act in contravention of their contractual obligations, unless the creditor has failed to disburse the resources as stipulated in the contract. Indeed, the principle of *pacta sunt servanda* is so entrenched in present practice that any discussion of the reduction of claims of creditors is described in terms of “relief,” “assistance,” and “forgiveness.” This principle is reflected in the fact that official and multilateral creditors are treated as within their rights in demanding concessions from the debtor country or even changes of a fundamental type in their domestic political and economic order in exchange for offering such reductions. Indeed, the strong presumption against voiding or fundamentally altering contracts—for example, in sovereign bankruptcy procedures—is evident in the two major policies that were implemented in response to the severe 1982 debt crisis. The Baker plan, which combined increased lending to restructure falling repayment with “market-oriented reforms,” and the Brady plan, which introduced a market in which previously issued sovereign debt obligations could be traded were both designed to restructure or refinance existing claims, even at a discount from original value, but thus avoid deep reductions, defaults, or voided contracts.

While there are, of course, limits on what creditors can do to enforce their claims, there are powerful incentives for borrowers to repay them, even if they deem them to be in some way illegitimate (Jayachandran and Kremer 2006). And the general view of the private creditors is that that domestic and international law should be reformed to make contracts more enforceable (Porzecanski 2003).<sup>5</sup> Their view is partly motivated by a desire to make *creditors themselves* more disciplined in honoring contracts. It has been a practice of the G7 countries (the major bilateral creditors) and the IMF to provide “rescue” packages to debtor governments of strategic importance, either for geopolitical reasons or for reasons of economic exposure, such as when the banking sector of a creditor country has lent significant amounts without proper loan loss provisions. It is also motivated by a strong belief that a sovereign’s failing to honor its contractual obligations involves the unfair treatment of creditors.

Governments that anticipate that they may have trouble servicing their debts are always at liberty to request that their creditors restructure the repayment obligations of their loans. However, each creditor is always at liberty to reject this appeal and instead demand full repayment on the terms specified in the original contract. And this is so regardless of how many other creditors recognized the need to restructure or forgive part of the debt. Indeed, when combined with the rigidity of sovereign contracts, *pacta sunt servanda* leads to so-called vulture funds—private investor firms which purchase the strongly devalued bonds of financially troubled governments, commonly referred to as “junk” bonds, for the sole purpose of refusing to participate in future restructuring and instead seeking to recover the full value of the bonds by taking the government of the borrowing country to court. For example, in 2000, after four years in the courts, Elliott Associates, a U.S. hedge fund that bought “distressed” Peruvian bonds for \$11.8 million, forced the government to settle for almost \$56 million (*Economist* 2005). In the aftermath of Argentina’s default, 24 percent of all private creditors refused to participate in a negotiated restructuring (in which Argentina offered to pay 35 cents on each dollar it owed). Some thirty-nine suits have been filed by noncooperating bondholders, in which they are seeking to recover \$7 billion in currently defaulted bonds (see Gotkine 2005 and Balls and Thomson 2005). Among these is NML Capital, an offshore hedge fund affiliated with Elliott Associates, which is currently suing Argentina for the recovery of more than \$170 million of bonds it bought at a deep discount (United States Court of Appeals 2005).

The emerging practice of inserting collective action clauses (CACs) into bonds, which bind all bondholders by the decision of a supermajority to agree to some restructuring deal with a sovereign debtor, partly diminishes the rigidity of sovereign debt contracts, but it does not really diminish the centrality of the norm of *pacta sunt servanda*, since creditors *considered as a class* retain full rights with

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<sup>5</sup> The recent reforms in the United States to tighten the conditions under which individuals may declare bankruptcy are also evident of this view.

respect to how to treat a debt (for critique of CACs, see Palley 2003). And, such clauses have been designed only for private, and not official creditors.<sup>6</sup>

The preeminence of *pacta sunt servanda* may also help to explain why no transparent criteria regarding eligibility for debt reductions exist.<sup>7</sup> Insofar as debt relief is conceived as involving the fully voluntary reduction of a rightful claim, then why should creditors not be permitted to exercise broad discretion with respect to their choice of beneficiaries and the terms on which such benefits are conferred?

## V. Contractual Rights and Obligations: The Ideal Picture

What justifications might be given for *pacta sunt servanda* as the fundamental norm governing economic exchanges related to sovereign debt, for granting governments internal and external sovereignty, and for maintaining debt contracts that are rigid, neutral, and extensive? To examine this question, it is useful to explore some of the considerations in favor of allowing agents to make binding agreements with one another involving the provision of resources by one in exchange for certain rights to demand resources in the future from the other.

Let us imagine that there are two agents, A and B, who are faced with the choice of whether to make an agreement with one another. This agreement—in the form of a debt contract—would involve the provision of resources from A to B in return for B’s promising to repay A according to a schedule agreed in advance.

Let us imagine that the interaction between A and B is characterized by the following conditions:

- (1) *Rational Individualism*. A and B are simple, individual agents with ordered preferences, who generally act rationally to satisfy those preferences. Because of this, A and B are qualified to bear the full risk of loss and the full potential reward that their agreement may bring.
- (2) *Formal Freedom*. Both A and B are *formally free* agents: neither has the right to unilaterally dictate the terms of their interaction.
- (3) *Substantive Freedom*. They are *substantively free* agents: neither A nor B can, by dint of their superior power, exercise effective and unilateral control over the terms of their interaction. Both A and B have a range of meaningful

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<sup>6</sup> And of course also since the nature of the debt contract itself stipulates these conditions in advance. To see model CACs, see Group of Ten 2002; and EMTA 2003.

<sup>7</sup> Kunibert Raffer and Hans Singer point out that creditors have arbitrarily decided on thresholds, countries, and amounts of debt reductions. They note that creditors had until recently maintained that no debtor country was eligible for reductions at all, insisting on full repayment, while claiming that countries would “grow out of debts” (Raffer and Singer 1996: Chapter 10). For criticism of the eligibility criteria of the HIPC initiative, see Raffer and Singer 1996: Chapter 11, UNCTAD 2004, Eurodad 2001.

conduct options, at least some of which involve refraining from engaging in financial transactions of the type that they are entertaining.

- (4) *Informational Adequacy*. Each of A and B is not only competent to understand the terms of the agreement that they are entertaining, but each has reasonably accurate information about the risks and potential benefits of making the agreement or refraining from doing so. A and B are roughly equal in the amount of information that they have or could potentially acquire about the risks and potential rewards of their agreement.
- (5) *Stability*. The environment in which A and B interact is relatively *stable*—there are few unforeseeable changes that can occur which would fundamentally change the circumstances of A and B in general and in particular their capabilities to comply with the terms of the agreement that they are considering.

When the conditions characterizing the ideal picture hold, there is a broad range of ethical considerations that can be advanced in favor of allowing A and B to make agreements of the kind imagined, for taking B to have an obligation to repay according to the schedule stipulated in the agreement once it has been made, and undertaking measures to ensure that such agreements can be effectively enforced.

One common set of considerations are broadly “rule” consequentialist in nature, to the effect that people are, on the whole, much better off when agents are given wide discretion about which agreements to make, when they are taken to be obliged to keep agreements that they do make, and when such agreements are generally enforceable. There are at least four reasons why such considerations might be thought to apply. First, such a practice *allows* agents to enter into mutually beneficial agreements. If A lends to B because B promises to repay her at some later time, this is because A believes that she stands to benefit from such an agreement. And if B borrows from A in return for her promise to repay A later, this is because she too believes that she stands to benefit from such an agreement. Since A and B are rational, formally free, interact in a relatively stable environment, and have reliable and roughly equal information about the risks and potential benefits of proposed agreements, there is reason to think that they will generally enter into those and only those agreements that will indeed benefit them. Second, such a practice provides strong incentives for agents to make prudent decisions not only *ex ante* (when deciding whether or not to make agreements), but also *ex post* (when deciding how to manage their affairs after they have made them). An agent who is deciding whether to make an agreement will think twice about making false promises or breaking their promises if they know that they will be held accountable for doing so. Third, absent such a practice, those who might provide resources to others that could be put to productive use will not do so since they will lack sufficient assurance that they will be repaid (Hume 1740/1978). Finally, such a practice facilitates the provision of more reliable information to all agents about how others will act, ensuring greater predictability and thus facilitating well-

informed future planning (Hardin 2002). Human beings have interests in knowing what others will do and also in being able to provide reliable signals about what they will do, and such a practice serves these interests (Scanlon 1998).

There are also non-consequentialist considerations that support aspects of these practices. For example, there seems to be a general connection between such practices and autonomy. Allowing persons, through consent or agreement, to bind themselves to do certain things for others is required if their autonomy is to be respected. As Joseph Raz has put it, “The ideal of autonomy is the vision of people controlling, to some degree, their own destiny, fashioning it through successive decisions throughout their lives” (Raz 1986: 369). Part of this control includes the power (in Hohfeld’s terms) to alter the claims that others have with respect to one’s future conduct. Keeping one’s agreements, moreover, seems generally connected with showing respect for persons. In making false promises or breaking agreements agents seem usually to show inadequate respect for others who are often significantly and avoidably harmed by this conduct (Kolodny and Wallace 2003). If B promises to repay A for resources that A has lent to her and later fails to do so, she induces false expectations in A that may lead to very dire (and avoidable) consequences for her (Thomson 1990, Scanlon 1998).

Making false promises or breaking agreements also seems to violate a duty of fair play (Hart 1955, Rawls 1999). B would gain from making false promises or breaking her agreement because she unfairly free rides on practices that are sustained by others who keep their promises. What is worse, if B gets away with this conduct, this may weaken confidence in the practices of agreement making and promising, which in turn may reduce their benefits to all (Kolodny and Wallace 2003).

There are still other values surrounding these practices. The practices of promising and agreement-making arguably contribute to the ethical development of persons. Being able to bind myself through promises to do things for others strengthens my sense of agency in the world and my responsibility for the exercise of my agency. This value of granting freedom to make agreements (and trust on the basis of promises they involve) is well understood by parents, who sometimes grant greater freedom of this kind to their children than may be warranted because of its important role in their children’s ethical development. Finally, the honoring of one’s agreements might be linked to the maintenance of personal integrity. As Chesire Calhoun has put it, “Persons of integrity treat their own endorsements as ones that matter, or ought to matter, to fellow deliberators. Absent a special sort of story, lying about one’s views, concealing them, recanting them under pressure, selling them out for rewards or to avoid penalties . . . all indicate a failure to regard one’s own judgment as one that should matter to others” (Calhoun 1995: 258).

Taken together, these considerations support granting quite a lot of weight to practices that grant agents broad liberties to make agreements, create stringent obligations for these agents to honor the agreements that they make, and ensure that

such agreements can be enforced. Situations may of course arise in which the consequences of such practices will seem problematic. Imagine, for example, that after the time of making the contract, B makes imprudent choices that make it impossible for her to repay A without great difficulty and at great sacrifice of other important objectives that she values. Such a system will hold that she nevertheless has a stringent obligation to repay A, and that this obligation should be enforced. That this practice leads to such a regrettable outcome, however, does not seem to provide decisive reasons to reject it, especially since such cases are likely to represent exceptions in an otherwise well-functioning system. In extreme cases we may still hold that B ought to act against her stringent obligations. We may also claim that while not obliged to do so creditors ought nevertheless to forgive loans or at least offer generous terms for restructuring them.

## **VI. Contractual Rights and Obligations: The Real Picture**

The discussion above suggests that, were it to be shown that lending and borrowing relationships involving sovereign states relevantly and significantly resemble the relationships in the ideal picture, then current practices related to sovereign debt would seem well supported, even when these practices lead to regrettable outcomes.

Yet, if such regrettable outcomes arise very frequently, it seems no longer appropriate to speak of them as exceptions in a well-functioning system. Currently, the high incidence of severely indebted countries that are unable to pay up their debts without sacrificing significant portions of their budgets would suggest that there might be a serious divergence between the ideal picture and reality.

And indeed there is. With respect to all but the second condition (formal freedom), the current circumstances in which sovereign debtors and their creditors interact differ quite radically from the conditions characterizing the interactions of A and B in the ideal picture. Consider, for example, the following four types of differences that seem particularly relevant for assessing the fairness of current arrangements for dealing with external sovereign debt:

1. Sovereign debtors (and also usually creditors) are not typically individuals, but complex collective agents made up of many present and future individuals.

Two aspects of these collective agents are particularly important to recognize. First, the individual agents who are empowered (via external and internal sovereignty) to agree to the contract and those who can potentially benefit from or be harmed by it are often different. Second, the interests of those who are collectively bound by the agreement are not always given adequate consideration by those entering the contract, nor are they (nor in the case of future persons or very young children *can* they be) adequately consulted about it.

Indeed, many debtor country governments are not even *minimally* representative of the interests of those they rule. With respect to debts contracted by governments of this kind, *combining* internal and external sovereignty with *pacta sunt servanda*



seems extremely implausible: By what right should oppressive elites be entitled to run up debts in the names of those whom they impoverish (or worse) and bind the present and future citizens of their country to repay it (Khalfan, King, and Thomas 2003; Jayachandran, Kremer, and Shafter forthcoming 2006). The prevalence of debts that were *either actively acquired by or easily traceable to* non-minimally representative regimes also calls into question the unconstrained privilege to lend: By what right can a creditor provide resources to a dictator that she has reason to believe will be used to harm the people of his country, and which cost will later have to be paid by them (Pogge 2001a)? And by what right can a creditor *escape* responsibility for compensating for the harms to which they have contributed, and in fact benefit from them (Raffer 2003)? For this reason, it seems far-fetched that granting external sovereignty to governments that are not even minimally representative while insisting on *pacta sunt servanda* will contribute to their “ethical development.” Furthermore, should some future, more democratic, regime refuse to pay debts that have resulted from reckless lending (or should the citizens launch a taxpayer revolt on the grounds that they should not be compelled to service invalid debts) it seems implausible to claim that they are failing to respect others. *They* never made promises to anyone or agreements with them, nor had their interests reflected in agreements that were purportedly made on their behalf. For these reasons, considerations of “integrity” also seem out of place, since they can perfectly well treat their own endorsements as ones that matter, or ought to matter, to fellow deliberators but deny that they should be bound by the endorsements of others in agreements about which they were neither consulted nor considered.

Even with respect to regimes that are at least minimally representative, it is evident that the disincentives to reckless borrowing that are present in the ideal picture are much weaker with regard to debtor countries’ governments, since those taking out the loans will not have to pay most (and in some cases any) of their cost.

2. While generally formally free, many debtors are often not substantively free in any relevant sense. This is so both because other agents, including creditors, can profoundly influence the terms of their interaction without their consent, and because they are often in so vulnerable a condition that refraining from entering into debt contracts with creditors (even particular creditors) is often not a meaningful option for them. As Joseph Stiglitz has recently pointed out, borrowers are typically much poorer than lenders, often they turn to them in times of crisis, and face an oligopolistic market for credit: “credit markets are highly imperfect: borrowers typically have access only to a limited number (usually one, two or three) of sources of credit, while creditors face a large number of potential borrowers” (Stiglitz 2003: 5).

These features of the relationships between creditors and sovereign debtors suggest that the practice of combining *pacta sunt servanda* with unconstrained rights to lend is highly unfair. By allowing creditors to demand nearly whatever terms the market will bear, this practice encourages lenders to take undue advantage of borrowers. Indeed, a strong case can be made that international financial institutions, developed

countries, and creditors based in developed countries have indeed on occasion taken double advantage of developing countries. That is, they have sometimes encouraged them to borrow large amounts, raised the costs of their repayment, encouraged them further to borrow still more money to repay the earlier debts that they could not feasibly repay, simultaneously encouraged (or demanded) further policy changes (such as currency account liberalization) which made their economies still more vulnerable and thus less able to service their debts and meet the needs of their people (BIS 2001, Pettifor 2003, Raffer 2004; Stiglitz 2002).<sup>8</sup>

3. It is very often the case that there are strong informational asymmetries between borrowers and creditors, and that borrowers have severely inadequate information about the risks that they may face. Developed countries, multilateral institutions, and private creditors are often in a better position than are developing countries to know what prudent levels of debt for these countries are, and how best to manage the risks that they face (Stiglitz 2003). This is partly because of superior resources and expertise, but also (as mentioned above) because they influence the overall global economic environment to a greater extent. Current practice thus creates significant incentive problems. Those with more information can easily take advantage of those without such information. Creditors may encourage vulnerable developing countries to enter into debt contracts that they know are imprudent. Indeed, this is arguably what occurred in the period leading up to the 1980s crisis (Raffer and Singer 1996).

There are, of course, some incentives for lenders not to make such loans, including the prospect that they will not be repaid. However, two factors somewhat diminish the significance of such incentives. The first is that creditors at least know that if debtors encounter difficulties in meeting their payment obligations, they will enjoy a privileged position in any further negotiations with the debtor. It will be up to them to forgive or restructure the contract, and to determine the terms on which this should be done. Given this privileged position they may benefit significantly in the long term from such restructurings, not only relative to what they would have had without having made the agreement but also relative to what they would have had were the borrower to have honored the original terms of the contract.

The second is that creditors themselves are collective agents, and those who are authorized to extend credit to borrowers can often reap the benefits of having done so without bearing the costs in case of default.<sup>9</sup> The financial manager who makes a debt contract with a sovereign may benefit himself by broadening his portfolio, yet be long gone when the sovereign becomes unable to repay the loan on the originally stipulated terms. Indeed, those who bear the significant personal cost of so-called non-performing loans are often not those who extended the loan or even other

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<sup>8</sup> Indeed, U.S domestic law traditionally has regarded with suspicion loans to poor persons in distress, such as by payday lenders or check cashers.

<sup>9</sup> Though it is generally not discussed, this problem also applies to the case of official lenders whose governments are undemocratic—such was the case with lending by the former communist regimes of Eastern Europe, and as it might some day arise with respect to China.

members of their institutions, but ordinary persons whose pensions and other investments are linked to these contracts. In the case of Argentina, many institutional investors presented overoptimistic prognoses of the country's economic prospects, since increased holdings of bonds brought individual investment bankers, brokers, and money managers personal financial gain, as well as institutional profits in fees charged to clients for performing services (see Blustein 2003).

4. The global environment in which sovereign debtors and creditors interact is quite *unstable*—there are many changes that can occur which would fundamentally change the circumstances of debtor countries which are not only impossible for them to *control* but which are also quite difficult for them to *foresee*. Instability of this kind raises particularly serious questions about present practice when the lender's behavior adversely affects the debtor such that it is much more difficult for them to meet their payment obligations. Suppose some very rich and powerful country G1 provides loans to a weak and poor country G77 at time  $T_1$ .<sup>10</sup> At time  $T_2$ , G1 decides to raise interest rates in response to fears about inflation in its domestic economy. Given its position in the world (that is, the size of G1's market represents a significant share of the world market, G1's currency is a "hard" currency in international financial transactions, and so on), this domestic decision affects the cost of borrowing in the world as a whole. Because poor countries like G77 typically "roll over" their debt, taking out fresh loans to meet prior debt obligations, increases to the cost of borrowing make it extremely hard for them to service their debts, including their debts to G1. Consequently, G77 can no longer meet its monthly payments to A at time  $T_3$  and is unable to pay down either the principal, or even pay the interest on the principal.

This is not a hypothetical example. Most prominently, the 1982 debt crisis unfolded after the U.S. Federal Reserve raised the interest rate to curb domestic inflation, thus raising the cost of borrowing (Reddy 2005, James 1986). This policy also contributed to a recession that significantly reduced the United States' demand for imports from developing countries. Developing countries were thus also less able to sell their exports, sales that were necessary to generate the foreign currency sufficient to meet their contractual obligations to their creditors. Similarly, the financial liberalization, followed by free capital flows and consequent monetary and asset price volatility, led and promoted by the finance ministers and central bankers of G7 countries, has, according to the Bank for International Settlements, "arguably also increased the scope for pronounced financial cycles," which "have all too often ended in costly banking system crises." The bank has concluded: "While both industrialised and emerging market economies have been affected, the damage caused by financial instability has been particularly serious for emerging market countries" (BIS 2001: 123).

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<sup>10</sup> This example draws on the discussion of the role of U.S. monetary policies in the debt in Reddy 2005. See also James 1986 and Raffer and Singer 2001.

In some cases where the decisions of one agent greatly undermine the capabilities of agents who are indebted to them, we may wish to argue that this weakens their ethical claim even to the principal. In others, we may grant the validity to the claim to repayment of the principal, but hold that the lending agent's behavior weakened or invalidated their claims to repayment on original terms on which they could demand repayment. Of course, when we judge the lender to have affected the debtor's position through "fair competition," we will find the causal relevance of the lender to the debtor's position at a later time irrelevant, but it seems far-fetched to claim that either greatly influential unilateral decisions such as occurred in the case of the interest rate hike, or the pressuring of countries to liberalize their financial markets when the risks of doing so were known to finance ministers and central bankers of G7, should be conceived as part of fair competition (Raffer forthcoming). Such instability also suggests that the rigidity of present sovereign debt contracts is questionable.

This section has shown how many considerations that might be invoked to support current practices relevant to sovereign debt have much less force than might initially have been supposed. It doesn't follow from this, of course, that significant reforms are ethically required or are even desirable to bring about. It may be that reforms which mitigate some of the regrettable outcomes of present practices may cause other (and perhaps even more serious) problems, and that proposed reforms may even have the opposite of their intended effect. Despite the evident problems with the current system, for example, it might still be defended on rule-consequentialist grounds. The importance of global capital flows to developing nations in today's globalized environment is significant, and any policy that established a wide range of doubt for creditors about which of their loans might subsequently be deemed void might cause more harm than benefit to developing countries and less advantaged persons within them (see, e.g., Boorman 2003; Jayachandran, Kremer, and Shafter forthcoming). Even minimally unrepresentative regimes may borrow for legitimate purposes. For this reason reforms that significantly constrain their rights to borrow (and others' right to lend to them) may seriously damage the interests of ordinary people living in the countries that they rule—especially if there are no foreseeable prospects for regime change—thereby harming the very people such reforms are intended to help. In the following section we will describe reform proposals that have features which provide reason to believe that they would help those currently disadvantaged by current practices, and do so in a way that would not impose undue burdens on others. Our purpose in outlining them is not to fully endorse any of them—this would require much more detailed empirical investigation of whether they could be feasibly brought about and maintained, and what their long-term effects would likely be—but to stimulate thinking about what appear to be promising alternatives to the existing status quo.

## **VII. Developing Alternative Norms and Institutions**

Our discussion of the ideal and real picture of contractual rights and obligations suggests two general approaches to remedying the problem of international debt. First, we can try to alter the actual nature of relationships of creditors and debtors so

that they more closely resemble the relationship of A and B in the ideal picture. Second, we can try to alter features of present practices in a way that more adequately takes account of the differences between the actual nature of relationships between sovereign debtors and their creditors and the relationship between A and B as sketched in the ideal picture.

The scope of the first approach is and will likely remain somewhat limited, since it is clear that many of the fundamental characteristics that distinguish present relationships between sovereign debtors and their creditors from the relationship between A and B in the ideal picture cannot be easily or substantially altered, and still others cannot be altered at all. Debtors and creditors will continue to be complex, collective agents, and for the foreseeable future they will possess unequal power and unequal access to information and will continue to interact in an environment that can be quite unstable. To be plausible, proposed reforms to current arrangements must be designed and implemented in light of these facts.

The second reform approach, which would involve changing features of debt contracts, limiting the internal or external sovereignty of borrowers, limiting the lending privileges of creditors, or departing from the norm of *pacta sunt servanda* thus seems more promising (at least in the short term), since it might change the incentives of creditors and sovereign borrowers without wishing away enduring if often regrettable features of our present global order.

In reality any particular reforms will necessarily represent a mixture of these two general reform approaches—as indeed do the proposals we outline next. These proposals have various valuable objectives. However, since our concern here is with reducing the negative social consequences that arise under the present system, it is useful to think of them in terms of whether their primary intended systemic effects are (1) to deter lending that we may have good reasons, *ex ante*, to think would produce morally objectionable consequences (while encouraging or at least not discouraging lending that is likely to be beneficial in the long term to the creditor and debtor alike); or (2) to deal, *ex post*, with negative consequences that have arisen from lending (even those that were perhaps difficult to foresee).

Proposals of the first type generally involve constraining creditors' lending privileges and, in such way, diminishing borrowers' effective ability to borrow in certain ways and for certain purposes. They also seek to change the character of those contracts that are entered into, making them: (1) less neutral—by making creditors' claims and obligations in part contingent on what borrowers do with the resources that creditors have provided to them; (2) less extensive—by specifying circumstances under which present and future citizens may be shielded from repayment obligation; and (3) less rigid—by making repayment obligations contingent in specified ways on the circumstances of the creditor or debtor or of the environment in which they interact.

Proposals of the second type require that less decisive weight be given to the principle of *pacta sunt servanda* in certain circumstances.

*Reallocating the Costs of Harmful Policy Advice and Lending*

Two proposals, recently advocated by Kunibert Raffer, would reallocate the costs of harmful policy advice and of harmful lending (Raffer 2003). Since the early 1980s, international financial institutions (IFIs) have assumed a significant role in giving economic policy advice to developing countries. They have also made extensions of loans to their client countries conditional upon implementing sectoral economic reforms, particularly through “structural adjustment programs.” While the empirical assessment of the impact of these programs remains hotly disputed, there are aspects of them that seem to have been flawed, and of which IFIs were, or could have been, aware at the time—such as defining a country’s level of sustainable debt. Recently, IFIs have themselves acknowledged that their projections of growth and exports, which are used to determine debt sustainability, were overoptimistic and failed to take into proper account the probability of external shocks that can affect export earnings and exchange rates (IDA and IMF 2001, IMF and IDA 2004). And, according to the World Bank’s Operations Evaluation Department, “the overall simple average of the growth rate assumed in DSAs [debt sustainability analyses] . . . is more than twice the historical average for 1990–2000, and almost six times the average for 1980–2000” (Gautam 2003: 28). For example, in the run-up to the 1980s debt crisis, Latin American countries’ debt was deemed sustainable on the basis of the results of models that failed to take into account the possibility of a sharp drop in commodity prices during the mid-1980s (UNCTAD 2004: 20 refers this claim to Cline 1995, cited in Claessens et al., 1996). The IMF and the World Bank have also acknowledged that some “completion point” countries—that is, countries that have fulfilled the requirements under HIPC and are ready to see their debts cancelled and graduate from the program—such as Uganda have debt-to-export and debt-to-GDP ratios exceeding sustainable levels as defined under HIPC, due to the drastic fall in commodity prices from the late 1990s through 2002, overoptimistic assumptions for economic and export growth, and in some cases new borrowings (UNCTAD 2004: 21; IMF and World Bank 2002).

Basing key criteria used for designing specific policy reforms on such flawed assumptions creates negative prospect for the success of IFI programs in restoring a country’s economic viability. Indeed, though it is probably impossible to show conclusively, due to the complex nature of macroeconomic policy-making and the multiple actors involved in it, it is not implausible that in some cases in which a country’s economic crisis worsened, such IFI programs may have contributed significantly to this outcome.

Under present rules, when a client country becomes insolvent, the repayment of obligations to IFIs takes priority over those to other creditors. The rationale that underlies their “preferred creditor status” is that the IMF and the World Bank provide loans to countries in especially difficult balance-of-payment situations, to whom no other creditors are willing to lend because of the high risk of their

defaulting. Ensuring that the funds they loan out will be replenished allows IFIs to shoulder the high risk.

However, this rationale can hardly be supported in light of the fact that IFIs contribute to increasing the risk of defaults with policy advice based on incorrectly designed programs. Protecting IFIs from losses comes at the expense of the poorest countries. Indeed, this creates a moral hazard: “When its strategy goes wrong, the IMF does not walk away. It stays, condemning the policies its former model pupil had to implement as inefficient and economically ill-advised, selling new advice, and helping with another program the country has to pay for” (Raffer 2004: 75). It is reasonable to suggest that when IFIs work with a country to implement economic policy reforms, they ought to bear part of the risk of these policies being unsuccessful, and thus also some part of the costs when they turn out to be unsuccessful.

Because it is extremely difficult (if not impossible) to determine the precise share of responsibility of IFIs for situations of insolvency that arise following policy reforms advised by IFIs, a minimal reform that would also remove the moral hazard would be to demand that IFIs absorb the same share of unpayable claims as do the other creditors. Indeed, it is not implausible to argue that IFIs should bear greater share of losses than private creditors, since unlike IFIs private creditors are not involved in giving economic advice to countries.

A serious concern associated with this proposal is whether the IFIs’ credit rating will deteriorate and thus make it impossible for developing countries to obtain cheap loans when they urgently need them. However, acknowledging publicly that a country has defaulted on its obligations to the IFIs is little different from the present situation of countries being in de facto defaults that, though not acknowledged, are publicly known. Provided that de facto defaults have not diminished the IFIs’ credit rating, it is not obvious why a formal, structured, and orderly mechanism of bankruptcy would. In addition, since 1986, when an external audit of the IMF indicated that the next audit will have to warn about the lower real value of some debts that were still booked at face value, the IMF has been building up “precautionary reserves,” or loan loss provisions, in order to preserve its standing as a creditor. In 2003 the surcharge that the IMF imposed on the loans it makes to client countries to insure itself for the case of a default averaged 0.1 percent (Raffer 2004: 73). It seems natural that these reserves will be put to use when actual losses do occur.

When it can be shown with some confidence that a creditor has inflicted harm on a debtor, and that this harm seems to have resulted from the creditor’s negligence, creditors might both have their claims to repayment be considered null and void and also be made liable for compensating debtors financially.

Introducing negligence standards into lending decisions and the design of economic policy programs by IFIs would create an incentive for IFIs to perform better—for

example, it will deter them from basing debt sustainability levels on flawed growth and export projections. Again, the cited reason for the lack of such existing mechanisms is the need to maintain IFIs' preferred creditors status. However, the International Bank for Reconstruction and Development (the World Bank's arm that lends to middle-income and creditworthy poor countries) has itself admitted: "Too many projects have been selected either on the basis of political prestige or on the basis of inadequate regard for their likely economic and financial rate of return" (IBRD 1984: 24, quoted in Raffer 2004). Where this has been the case, the ensuing failures or even damages to the borrowing country translate economically into costs of borrowing, albeit hidden since they are not reflected as points in the interest rate charged on the loans. Thus, if IFIs pay compensation for failing to act with proper care, or to observe professional standards, the total cost of borrowing that developing countries face might be lower, even after raising interest rates as insurance, because IFIs would act with greater care.<sup>11</sup> Like in domestic markets, it seems likely that the application of liability would be restricted only to cases where creditor negligence has resulted in serious harm.

A permanent international court of arbitration could be established to adjudicate cases of alleged negligence. For it, developing countries and international financial institutions would nominate the same number of members, who would then elect one further member to reach an uneven number of votes in order to avoid deadlocks. The right to file complaints would be conferred to NGOs, governments, and international organizations. The court will have investigative powers, and be able to invite outside opinion in the form of amicus curiae briefs. There are several examples of public debt audit initiatives that have been undertaken by countries' own parliament or civil society groups, whose methods, although in need for improvement, warrant attention. These include the audits of national debt that were conducted in Argentina starting in 1982, Brazil in 2000, the Philippines in 2004, and Uruguay in 2005 (Fontana 2005). Moreover, the court's powers need not be limited to investigating conformity with existing IFI operating norms, but should also extend to examining the validity of these norms. A court should be able not just to hear a case of whether IFIs have complied with their existing guidelines for designing conditionality requirements under an economic program, but also to review the soundness of the guidelines. In such way, it will contribute to repairing, where necessary, the rules with which creditors ought to comply. Damages for which the court finds IFIs to be liable could be covered in some cases by waiving repayment on part of the loans equivalent to the resulting damage. Notably, in cases for which it could be shown that the loans have been instrumental in harming them, additional transfers may be required. In such cases, simply releasing a government from obligations to repay funds that a corrupt predecessor regime used to enrich itself or that a dictator uses to further oppress those who oppose him or strengthen his grip on power—as was the case with the 1983 loan that the IMF provided to

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<sup>11</sup> This is not to discount the significance from a point of justice that the parties harmed would be able to receive compensation for damages. The systemic contribution of this reform, however, is to reduce the incidence of such cases arising.



Mobutu's Zaire—cannot plausibly be viewed as compensating them adequately for the harms suffered.

### *Creating Disincentives to Lend to Repressive Regimes*

Two proposals that would create disincentives to lend to repressive regimes and diminish the scope of internal and external sovereignty have been advanced respectively by Pogge and Seema Jayachandran, Michael Kremer, and Jonathan Shafter. Most people would agree that lending to severely oppressive regimes, such as Nigeria under Sani Abacha, Argentina during the military junta rule, or indeed Burma's current government, is at the very least highly questionable because it contributes to their maintenance and undermines local activists' efforts for reform. The current system, because it ensures that creditors retain legal claims to repayment under all circumstances, does not create disincentives to lend to such regimes. However, Pogge has argued that such disincentives could be introduced if countries prone to political and military coups passed a constitutional provision during periods of democratic governance, stipulating that in case of undemocratic regime change, the loans incurred by this undemocratic government will not be honored by future democratic governments (Pogge 2001a). This mechanism will be self-enforcing for cases in which a military regime takes over and suspends a democratic constitution. For the more complex cases of a government becoming undemocratic over the course of its term, the proposal envisions an international democracy panel of independent experts outside the country judging in real time whether a particular country remains democratically governed.

Such reform, if instituted, poses the danger of undermining access to credit for fledgling democracies. Authoritarian regimes will sometimes reemerge despite the deterrent effect of a constitutional amendment. When this happens, the new authoritarian government will lack an incentive to honor the debts that may have been incurred by the previous democratic regime, since it is banned from international borrowing whether it repays them or not. The likelihood of such scenario would make creditors apprehensive about lending to newly democratized countries. To solve this incentive problem, Pogge's proposal envisions the establishment of an international fund, backed by the major democratic countries, which could service debts of democratic governments in cases in which authoritarian regimes reject them. Indeed, the more financial backing that established democracies give to the fund, the less it may have to spend, since a fully credible fund will reduce the number of coup attempts. Indeed, it would create incentives for authoritarian regimes to become democratic in order to gain access to international resources, which is of special significance to countries in which regime changes rarely occur through elections.

In a similar spirit of raising the risk of lending to undemocratic governments, Jayachandran, Kremer, and Shafter propose the "due diligence model" of odious debt resolution, which envisions putting an international organization in charge of adjudicating *ex ante* that a certain regime is odious debt prone, subsequently creating a duty for creditors to employ reasonable best practices of due diligence to

ensure that the proceeds of their loans be utilized for pre-specified public purposes (Jayachandran, Kremer, and Shafter forthcoming). They are free to extend the loan without such due diligence, but if they do so and the debts incurred are indeed harmful to the population of the borrowing country they are shielded from repayment obligations. To ensure that creditors have sufficient certainty that their loan is given with proper due diligence for the specific circumstances of a country, prospective creditors would submit an analysis of their loan proposal, including its intended uses by the borrowing government and the due diligence structures put into place to monitor the implementation of the proposal, to the international organization. If the proposal were to be approved, creditors would be ensured the validity of their claims against the borrowing government, so long as there is sufficient evidence that the creditor made a good-faith effort to comply with the pre-approved due diligence structure. Some actually existing or new international political body could conceivably be put in charge of evaluating proposals.

#### *Reducing the Rigidity of Sovereign Debt Contracts*

To account for the instability of the global system, Sanjay Reddy has recently suggested that debt contracts could be designed (and could be demanded that they be designed) in a way similar to so-called contingent claims financial instruments, such as securities whose returns are linked to commodity prices or economic performance (Reddy forthcoming). Such derivative-like securities would require lower payment during economic hardship, and higher payment in times of prosperity. When circumstances arise over which debtor countries have little or no control and which significantly and adversely affect a debtor's ability to repay its debts on a predetermined fixed schedule—such as natural disasters, plummeting world prices of a country's major export commodity, or rising interest rates as a result of another country's monetary policy—contingency claims clauses written into contracts would describe a different set of repayment obligations. Such type of contracts in fact prevent potential moral hazard: by carefully specifying the contingencies that warrant reduced payments, the contracts eliminate debtors' abilities to manipulate events in such way as to "welch" (for an extensive treatment of this point, see Hockett 2004).<sup>12</sup>

Utilizing contingent claims instruments requires a system of monitoring and arbitration. Some third-party arbiter will be necessary in order to facilitate the operation of a system of legal definitions that can determine when the circumstances that could trigger a contingency claim have arisen. It might be feared that such a system would result in higher interest charges on loans to all borrowing countries, but this need not be the case so long as the specific characteristics of each country are known and publicly acknowledged.

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<sup>12</sup> In the United States, "income-contingent" student loans were pioneered by James Tobin in the late 1960s. In the 1970s, Yale University implemented such a plan, called the "Tuition Postponement Option."

### *Sovereign Bankruptcy*

Sovereign bankruptcy proposals seek to amend the current situation in which the negative consequences of severe indebtedness are borne nearly entirely by the population of the borrowing countries (unless of course creditors agree to forgive its debts). One such proposal is the Fair and Transparent Arbitration Process (FTAP), which has been advanced in various variants by civil society organizations. It is based on the proposal for an international insolvency procedure modeled on Chapter 9 of the U.S. Bankruptcy Code, which governs the bankruptcy of municipalities (Raffer 1990). The FTAP is a mechanism for the management of debt crises in a way that is “open, transparent, and accountable to citizens and taxpayers,” in order to ensure that their interests are heard and given proper consideration and that their basic rights are given higher priority than creditors’ rights. The FTAP is intended to be a neutral decision-making body, independent from both parties. It will consider the entire debt owed by a country, in contrast to the current practice of the debtor negotiating with individual classes of creditors for its respective types of debts. It envisions all types of creditors being subject to equal treatment, to address the concerns of private creditors that multilateral lending institutions are in a privileged position (and as is envisioned by the bankruptcy proposal advanced by the IMF, the Sovereign Debt Restructuring Mechanism).

The FTAP envisions the establishment of an ad hoc international arbitration panel (which reflects the above principles), composed of an equal number of representatives from the creditor and debtor sides, who nominate by simple majority one additional panel member. In addition, a small technical secretariat may be set up to support the harmonization of countries’ data, auditing, technical support to the arbiters, and the organization of the hearing of stakeholders according to procedural standards (Erlasjahr 2001). The benefit of an ad hoc arbitration panel compared to a permanent court is that arbitrations do not usually use a precedent system, hence failure or success in one case will not prejudice a future case (Afrodad 2001). This would make an arbitration panel more responsive to political considerations that are intrinsic to international relations in the absence of a global consensus on a common legal system.<sup>13</sup>

The purpose of the arbitration court is to protect at the minimum the basic rights of the population of the indebted country. However, its final rules could be informed by considering the full scope of relevant factors, including creditors’ and sovereign debtors’ due diligence. In this sense, the mechanism would create incentives for creditors to avoid such behavior in order to diminish the overall risk they face without creating incentives for sovereigns to take out imprudent loans because they know that they will be “let off the hook” through arbitration later on.

A major concern that has been voiced in relation to international bankruptcy mechanisms in general—including by some developing countries, such as South

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<sup>13</sup> Some civil society organizations call for charging the IMF with the provision of loans during the arbitration process (when participating creditors are not willing to lend to the country) and giving priority to the repayment of these loans over all others (Pettifor 2003).

Africa and Mexico—is that it might diminish the availability of credit to developing countries. The validity of these concerns however is not immediately evident. As noted earlier, it could be argued that the current high indebtedness of many countries amounts to a de facto, publicly known (though not officially acknowledged) default. Indeed, any new lending at present is premised on canceling some of the existing debts (see Erlassjahr 2003).

It is sometimes argued that despite the substantive promise of these proposals, the political space for their implementation is severely limited. Two proposals may help to improve the position of debtors under the current system, as well as create incentives to at least further consider proposals for reform.

#### *Shift the Power Balance in Bargaining*

Two suggestions are aimed at altering the power dynamics of negotiation and thus allowing debtor countries a wider range of alternative choices. One is to form debtor cartels, akin to creditor carters such as the London and Paris clubs. Negotiating as a group, debtor countries of similar situations will be better able to reject a settlement that advantages creditors and would result in a fairer outcome (e.g., Kapoor and Kapoor 2005).

Another is to move the debt renegotiation forum from creditor to debtor countries. This will expose negotiators from creditor countries firsthand to political pressure from the populations of debtor countries and make them better aware of the consequences of a negotiation outcome that is perceived as privileging the interest of richer creditors. In the longer term, direct exposure to the political pressure in debtor countries would create a better perception of the constraints placed on debtor governments in fulfilling their obligations to foreign creditors at the costs of political dissent at home.

#### *Alternatives to IMF Cancellation Conditionalities*

Under existing programs for debt cancellation, such as the HIPC Initiative and Multilateral Debt Cancellation Initiative (which resulted from the G8's June 2005 decision on multilateral debt cancellation), qualifying countries must comply with IMF-designed and monitored conditionalities, in order to benefit from them. While IMF conditionalities may be motivated by legitimate reasons to ensure that the canceled resources are used for development purposes, they are seen as highly controversial by developing countries. Peer-run trust accounts that provide a check on governance but are not controlled by donor governments could provide an alternative to IMF-imposed controversial conditionalities by separating the creditors' pledge to cancel debts from the actual delivery of funds.<sup>14</sup> As part of the condition for allowing a cancellation (and perhaps in the future, a bankruptcy

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<sup>14</sup> This proposal is outlined in Hertz 2005, and Kapoor 2005. The idea of peer trusts goes back to Paul P. Streeten, who proposed an emulation of the Marshall Plan model of self-monitoring by recipients in the mid-1990s. See Raffer and Singer 1996. NEPAD already administers such peer mechanism whose goal is to provide an overall check on governance although not explicitly with respect to debt cancellation.

settlement) to go forward, a country will be required to deposit an amount equal to its monthly debt payments into this trust account, from which the money will be transparently allocated to social expenditures on poverty alleviation, health care, and education.<sup>15</sup> The governing body of a country's trust would be made up of representatives from local civil society and neighboring countries. Since payments into the fund will be made in monthly installments, potential abuses could be halted in time with in-progress audits. A further check on the fund's spending could be provided by an independent international arbitral body. Whereas this model may not be suitable for cases of countries in strong intra-regional competition, as in South Asia, for sub-Saharan Africa, which has been spending four times more on debt repayment than on social goals, the major causes of regional tensions are themselves in many ways consequences of the health and poverty crises to which debt is a contributing factor. Indeed, for its case, this model is also likely to bring an added benefit—the exchange of knowledge among regional governments about transparent and effective governance practices that they themselves could design.

### **Conclusion**

We have not argued that bringing about these reforms is justified. Rather, we have described the ways in which these reforms might plausibly be viewed as addressing some of the apparently unfair features of present rules governing sovereign debt. We think these proposals are promising enough to warrant further intellectual and practical exploration. Whether they should be implemented cannot justifiably be determined in advance of such explorations. And it is therefore premature to judge whether or not, as some critics of these proposals have claimed, they are unworthy of consideration because they are politically infeasible to implement under current conditions. Though there are often various motivations for statements such as “[T]he sovereign bankruptcy option is simply too costly to contemplate under present institutional arrangements. Radical reform of those arrangements—creation of an international bankruptcy court—is patently unrealistic. Discussing these ideas is a waste of breath” (Eichengreen 1998), their effect is to advocate wrongly foreclosing discussion of these ideas, on grounds of that it is unlikely that they could be implemented in the very short term. That reforms turn out to be infeasible because influential actors remain implacably opposed to them—even though it is likely that they will lead to improved social outcomes—does not imply that we should abandon discussing them. It suggests instead that we ought to find ways to pressure these actors to meet their ethical responsibilities.<sup>16</sup>

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<sup>15</sup> Indeed, this idea may help to address the problem of how to deal with cases of countries whose debts may be illegitimate, yet creditors may be deemed ethically obliged to demand repayment because they have strong reason to believe that these resources would do more harm than good if left in the regime's hands.

<sup>16</sup> For a more detailed discussion of the relevance of feasibility concerns in assessing proposals for institutional reform, see Barry and Reddy 2006.

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