

Written questions to the experts/Answers from the Norwegian Ministry of Foreign Affairs

1. Describing the problem of illegitimate debts and the progress of international debate

- What are illegitimate debts and how did they come about?

The classical articulation of the doctrine, by A. N. Sack is as follows: "When a despotic regime contracts a debt, not for the needs or in the interests of the state, but rather to strengthen itself, to suppress a popular insurrection, etc, this debt is odious for the people of the entire state. This debt does not bind the nation; it is a debt of the regime, a personal debt contracted by the ruler, and consequently it falls with the demise of the regime. The reason why these "odious" debts cannot attach to the territory of the state is that they do not fulfil one of the conditions determining the lawfulness of State debts, namely that State debts must be incurred, and the proceeds used, for the needs and in the interests of the state. Odious debts, contracted and utilised, for purposes which, to the lenders' knowledge, are contrary to the needs and the interests of the nation, are not binding on the nation - when it succeeds in overthrowing the government that contracted them - unless the debt is within the limits of real advantages that these debts might have afforded. The lenders have committed a hostile act against the people, they cannot expect a nation, which has freed itself of a despotic regime, to assume these odious debts, which are the personal debts of the ruler. Even if one despotic regime is overthrown by another, which is as despotic and which does not follow the will of the people, the odious debts contracted by the fallen regime remain personal debts and are not binding on the new regime."

However, the criteria for debt relief are not carved in stone. On the contrary, they are the subject of continuous review. This process of change must be based on debate among both professionals and the general public. A discussion of fresh ideas and conceptual innovations must be welcomed.

International common law is based on the premise that new regimes take over the international obligations of their predecessors, regardless of the nature of the former regime. There are a few historical examples of this common law being challenged and wholly or partially set aside. The international debt relief movement has recently begun to refer to these examples in its arguments in favour of cancelling what is now called "illegitimate debt".

Non-governmental organizations usually define debt as being "illegitimate" when:

1. the debt was incurred by an undemocratic regime
2. the borrowed funds have been used for what are regarded as morally reprehensible purposes (such as the purchase of landmines or the financing of suppressive regimes)
3. repayment is a threat to fundamental human rights
4. the debt has grown to unmanageable proportions as a result of external factors over which the country has no control (e.g. higher market interest rates), and when
5. debt that was originally commercial is taken over by the government of a debtor country (through the triggering of government guarantees).

The sum of these criteria for illegitimacy" is a very finely-meshed net, in fact it is so finely meshed that it appears to catch almost all debt. If all these criteria are accepted (including items 4 and 5 above), to advocate cancelling illegitimate debt" may easily be seen as a recommendation to cancel all developing countries' debt. This can hardly be regarded as either appropriate or desirable.

How have international policymakers coped with the problem? (selected examples).

Over the years, many proposals have been launched for the establishment of new institutions in the debt field, often independent of the Bretton Woods institutions, in many cases inspired by US bankruptcy legislation, and in some cases linked to the UN. The purpose of such institutions has often been “arbitration” between creditors and debtors, possibly followed by a “ruling” and often with the aim of promoting more comprehensive debt relief, on the basis of an assessment that this would be fairer than the current debt relief arrangements.

Many of these proposals have come from academic institutions, which in turn have inspired the international debt relief movement to promote these ideas itself. One of many examples is the proposal for Free and Transparent Arbitration Processes (FTAP), which has been promoted by the Jubilee movement and is now supported by the Norwegian Campaign for Debt Cancellation (SLUG).

The debt relief movement’s agitation in favour of alternative debt work-out mechanisms has in some cases also inspired international organisations to present their own proposals. Thus, in 1998 UNCTAD launched a proposal for an international bankruptcy court. In his Millennium Report, UN Secretary General Kofi Annan suggested that the international community should consider the establishment of what he called a debt arbitration process with greater balance between the interests of creditor and debtor countries.

Kofi Annan’s proposal was not explicitly linked to the illegitimacy debate. This link has subsequently been made by the debt relief movement itself.

In November 2001 Anne O. Krueger, Deputy Chairman of the IMF, presented a proposal for a comprehensive Sovereign Debt Restructuring Mechanism (SDRM) for earlier, quicker, cheaper and less painful debt settlement. The SDRM was originally conceived as a joint framework for settling the commercial and official debt of middle-income countries, with the IMF itself playing a central role. However, this proposal was significantly modified as the debate progressed. In spring 2003, the proposal was de facto put on ice, primarily due to opposition from the USA (who wanted a more “market oriented” version) and some middle-income countries (who feared that the SDRM might have a negative impact on their creditworthiness).

Nevertheless, work is still in progress on a couple of less ambitious instruments. They are Collective Action Clauses (CACs) to persuade commercial creditors to negotiate jointly and a Code of Conduct for commercial creditors and their interaction with official creditors. Norway welcomes this work, but regrets that it has not been possible to reach international agreement on an SDRM.

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

It reduces the pro-poor spending, which reduces the chances of reaching the Millennium Development goals.

It could also be argued that it undermines the trust in the north-south relationship that development cooperation needs.

It could also create moral hazard – problems, if dictators can borrow, without any international reaction or sanction.

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

The debate has developed. It is today on the agenda in many creditor countries, international financial institutions and development organisations. However, there is still hesitation to discuss the issue.

Norway has financed studies of “illegitimate debt”, carried out by UNCTAD and the World Bank. These you will find enclosed. Both the UN and the World Bank have shown interest and willingness to discuss this topic during the recent years. Few creditor countries have shown further interest, but there seems to be some movement.

- What are the current aspects of the debate on illegitimate debts? How is this matter being discussed in developing countries?

How this matter is being discussed in developing countries is key and very important before going further. Besides Ecuador very few debtor countries has taken a stand on the issue. Ecuador has put down a Commission of Inquiry into the External debt (CEIDEX). To classify debt owed by a developing country as illegitimate could have both political and economic implications. (Is the debt illegitimate because the regime taken up the debt is illegitimate? Will the labelling of the debt as illegitimate impact the credit rating of the debtor country?)

- What effects are illegitimate loans having on financial markets? How should the term "moral hazard" be understood in relation to illegitimate debts?

The effect could be negative. The result could be credit drought. One can discuss if this possible effect will be seen in a shorter or longer term, since the eventual cancellation will make the developing country more debt sustainable. Also, the HIPC-initiative has, for many of the same countries, already cancelled a lot of debt. Therefore debt cancellation is not new and surprising for the financial markets. But, it is an issue we have to consider. That is why the debtors must also be heard.

Moral hazard is always relevant when we discuss debt issues. In relation to illegitimate debt it is relevant because a focus on the issue could change the behaviour of both creditors and debtors. Odious regimes considering taking up more loans could be encouraged to do so, regardless of the quality of the loan or purpose, because it will be cancelled later anyhow. At the same time, a stronger focus on illegitimate debt could change the behaviour of dubious creditors positively. If a creditor today wants to lend money to Mugabe or to the generals in Burma, the risk would be a lot higher with an international recognition of the doctrine on odious debts.

2. Necessary action and possible steps to curtail illegitimate debts

- What possibilities exist of stopping the practice of granting illegitimate loans? What role could international standards play in this process? What effects would international standards have?

International monitoring and cooperation is important to prevent the practice of granting illegitimate loans. Transparency, binding international rules and law and international guidelines are key words here. The new OECD Principles and Guidelines to Promote Sustainable Lending in the Provision of Official Export Credits to Low Income Countries, based on the World Bank's Debt Sustainable Framework, the UN Security Council, the new EURODAD charter on Responsible Financing and the Paris Club are examples of arenas and instruments.

The effect of international standards is directly correlated to the extent to which all creditors and debtors are parties to it and follows it. It is for example essential that the new emerging economies also are included.

- What criteria could serve as a basis for such standards? To what extent are Alexander Sack's criteria still applicable?

Sack's criterias are a lot easier to use as a basis for such standard than the extension in the contemporary notion of illegitimate debt (see our answer to first question). However, the criteria used by Sack and by the modern civil society overlap and some of the criteria in the contemporary notion of illegitimate debt should be considered and discussed further.

- What other criteria should the standards to be agreed upon embrace? To what extent should imperative principles of international law, rules protecting debtors, and maximum debt limits be applied?

DSF?

UN-sanctions?

- Which international players and institutions can and must establish such standards? What should be the role of G8 member states, and what should be the contribution of agencies like the World Bank, the IMF and UNCTAD? What can Germany do to influence these institutions?

All institutions mentioned must be involved, and many are. The G8 should lead and influence, through their membership in the relevant institutions.

The Report from the Secretary General for the 62nd General Assembly, points out the need to work on an internationally accepted debt workout mechanism that involves all creditors. We support looking deeper into this, including looking at the legitimacy of claims based on how the loans were given.

3. Treatment of long-standing liabilities arising from illegitimate debts

- Is it possible to estimate the size of long-standing liabilities which developing countries have accumulated from illegitimate debts? Which countries are particularly endangered in terms of their development as a result of such old debts?

Norway has no such estimation. It also varies a lot depending on what criteria you use. There are well known non governmental organizations arguing that there is "no such thing as legitimate debt". From their point of view the exploitation of the south and the poverty in the south makes it impossible to classify loans from the north to the south as legitimate. If those

criteria are used, it is easy to estimate the size of long-standing liabilities which developing countries have accumulated from illegitimate debts. Norway does not share this view. Such criteria both damage the important discussion on illegitimate debt and it would have put an effective end to all important loans financing development in the south.

- How can further debt-reducing initiatives help in dealing with illegitimate debts?

It could catalyse the normative approach on the matter. A unilateral action like the cancellation of the remaining claims from the Norwegian Shipping Export Campaign (1976-80) is an example:

In 2007 the Norwegian government cancelled the remaining claims from the Norwegian Ship Export Campaign (1976-80). This campaign represented a development policy failure. As a creditor country Norway has a shared responsibility for the debts that followed. In cancelling these claims Norway takes the responsibility for allowing these five countries to terminate their repayments on these debts.

These claims were cancelled unilaterally and unconditionally, without budgetary allocation and without reporting the cancelled amounts as Official Development Assistance (ODA) to the OECD. The debt cancellation will, in other words, be additional to Norway's ordinary ODA.

See enclosed FACT SHEET on the cancellation.

Norway would like to see other creditors take a critical look at their own portfolios of claims on developing countries. A key purpose of Norway's decision is, of course, to stimulate a debate on creditor responsibilities and responsible lending. We believe this debate must be given higher priority than has so far been the case.

This could help both dealing with illegitimate debts and help to discipline today's creditors.

- How should entirely private illegitimate debts be assessed and treated within the scope of future debt relief initiatives?

In principle, private debt should be assessed like bilateral and multilateral debt. In the Paris club, the comparability of treatment principle is essential. Without this principle, bilateral and multilateral efforts are subsidising the lack of private efforts. Within the scope of future debt relief initiatives, it is therefore important to apply the same principle.

- Should there be separate initiatives for the treatment of illegitimate debts?

The recent development of both new lenders, the rise of the domestic debt and Middle income countries' debt are all reminders that we need to work on an internationally accepted debt workout mechanism. Such mechanism should involve all creditors and all debts.

A final remark

A final comment to these questions and our view on where we think the greatest challenge is discussing this topic. The real challenge, from our point of view, is to agree on - and to operationalize criterias to separate legitimate and illegitimate debt. To read

more regarding the dilemmas and possible challenges, please read our enclosed Debt Policy, chapter 4.5 “Illegitimate Debt”