[14] Having defaulted at the end of 2001, Argentina made a take-it-or-leave-it swap offer of new bonds for old valued by the market at about thirty cents on the dollar in early 2005, and its Congress essentially declared that any original bonds remaining after the swap would be null and void; Argentina had claimed its bondholders had all along refused to enter into serious negotiations despite trying to engage them. The bondholders, on their side, said it was hard to negotiate, since the government was asking them to absorb unprecedented losses, which most of them did, as in the end 76 percent of the bondholders agreed to the swap.

[15] This is neither to deny that ODA debt is in practice often treated differently in negotiated debt restructuring, nor that several creditor governments long ago converted all their ODA loans into grants; it is rather that the practice is not universal, and considerable bilateral ODA is still given as loans and repayment is insisted upon and renegotiated as part of debt restructurings after recipient governments default.

[16] Although the Iraqi and Nigerian cases can be claimed as falling under the Evian Approach, the reality is that political forces and not economics drove the analysis.

[17] Following global recognition of the governance issue when heads of state and government included it in the Monterrey Consensus at the United Nations International Conference on Financing for Development in March 2002, it entered the agendas of the ministerial committees that oversee the IMF and World Bank. In April 2006, the IMF committee requested that concrete proposals for reform of the IMF be presented at its next meeting in September 2006, when it endorsed a two-year program of "quota and voice reforms".

[18] The phrase "lender of last resort" is used in a different sense here than in discussions of national central banks providing short-term loans to replace liquidity in the commercial banks in a domestic banking crisis.

[19] The IMF insists, nevertheless, that it does not and should not intervene in actual debtor-creditor negotiations on the terms of relief. Private creditors agree with the Fund on this, and one of the reasons that they so forcefully resisted the IMF initiative to create the Sovereign Debt Restructuring Mechanism in 2003 is they feared that the IMF would manipulate the debt negotiations from behind the scenes.

[20] The IMF has a large stock of gold, mainly paid in by members in its early years. The gold is valued on the IMF's books at an artificially low price and so any sale at market prices provides very large capital gains. The constraint on selling the gold is that gold-producing countries fear it will reduce the market price of their gold exports. The 1999 sale was thus artfully designed so the gold never hit the market and the sale was almost immediately reversed when the buying governments (Brazil and Mexico) used the gold to make loan payments to the Fund, leaving the IMF with its original physical volume of gold intact, albeit with some of it now carried on its books at the current market price.

[21] The exception is the European Bank for Reconstruction and Development, which was created in 1991 to assist in the economic transition of the formerly centrally planned economies of eastern and central Europe and the former Soviet Union. Its primary mission is to nurture private-sector development in those countries.

[22] Governments actually had to purchase outright only a fraction of the value of their shares as "paid-in capital," the rest being "callable."

[23] The IDA completed its fourteenth replenishment in 2005.

[24] In fact, many governments have prepared PRSPs with limited consultation, and in some cases World Bank staff themselves prepared PRSP drafts on an interim basis. While some fault the Bank for not pushing hard enough for civil society involvement (or for not taking challenging civil society views on board when expressed), the PRSP exercise seems a unique foreign intervention into borrowing country politics.

[25] The argument has forcefully been made by Kunibert Raffer, an author in this issue (see citations therein).

International Debt: The Constructive Implications of Some Moral Mathematics

*Sanjay G. Reddy**

Can current norms and institutional arrangements in regard to the accumulation and discharge of international sovereign debt be morally justified? If not, what sorts of modifications to these norms and arrangements would be required for such justification? These are live questions, as may be attested to by anyone who pays heed to contemporary debates over international economic relations. Some of the most active debates have centered on the moral obligations of creditors who are faced with poor countries that are heavily indebted. Some of these poor countries appear to be sacrificing the present and future well-being of their populations in order to undertake debt service, sometimes for debts which were accumulated by predecessor regimes of questionable legitimacy for purposes of questionable value. In this essay, I attempt to address the questions raised above in a preliminary manner, presenting some suggestions as to the shape of possible reforms.

A central proposition to be assessed holds that *states are capable of incurring and sustaining obligations over time.* This (perhaps apparently innocuous) proposition, which we will refer to as the proposition on the moral agency of states, refers not only to the empirical capability of states to enter into legal obligations, but also to the ability of states to take on responsibilities that are morally binding. The proposition is normative in content, since obligation is a normative concept.

It is helpful to assess a proposition of this kind from the perspective of normative individualism, the view that it must in principle be possible to derive moral propositions concerning collective agents (such as states) from moral propositions concerning individual agents. In particular, the perspective of normative

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individualism suggests that we can attempt to understand how the obligations that we attach to a state may derive, or may fail to derive, from the moral properties of individuals and their capability to enter into certain kinds of relationships (generating moral obligations as a consequence).

THE DOMESTIC CASE

Moral intuitions concerning the obligations of states to fulfill the terms of their international debt contracts frequently appear to be heavily influenced by the analogy to domestic contracts (involving individual persons or firms). It is commonly accepted that an individual ought to fulfill contractual obligations that she entered into in the past, except in exceptional circumstances. This moral presumption derives from basic considerations of personal integrity. It is thought to be essential to moral personhood itself that a person must take responsibility for her own words and actions. It is also thought that the threads that link a person to her future self (generally) preserve this requirement of moral responsibility.[1] This presumption gives rise to a burden to fulfill promises (at least in the absence of sufficient countervailing reasons). It would be very strange to imagine a system of moral reasoning in which there was *no* such requirement for individuals. The burden to fulfill promises can give rise to a prima facie obligation to fulfill past promises, both on the part of individuals and on the part of entities constituted by the actions of individuals (such as firms). Other related considerations, such as a burden on individuals to refrain from taking unfair advantage of others, may also play a role in creating a requirement to fulfill contractual obligations (on the fulfillment of which other persons have come to depend).

In addition to these deontological considerations, there are also consequentialist considerations that underpin the presumption that contractual obligations of specific kinds (such as debt contracts) should be fulfilled.[2] These consequentialist considerations appear also to have an important role to play in the justification of a burden on contracting parties to fulfill their obligations. Where specific exemptions from such a burden are recognized (in bankruptcy law, for instance), this is in large part because it has been thought that good consequences are generated by the upholding of such exemptions.[3] The consequentialist reasoning involved in the upholding of rules has been extensively explored in the philosophical literature, such as that on rule utilitarianism, and in the literature of related fields, such as law and economics.

Both deontological and consequentialist forms of moral reasoning appear implicitly to underpin the common presumption that domestic debt contracts ought to be fulfilled, as summarized in the legal slogan *pacta sunt servanda*—"pacts must be respected."

THE ANALOGY AND DISANALOGY TO THE DOMESTIC CASE

The simplicity of the analogy to the domestic case and its familiarity from everyday life is undoubtedly in part responsible for the influence of that analogy. In fact, the case of a state incurring and maintaining international obligations over time is both analogous and disanalogous to the case of domestic contracts.

Even in the emblematic case of individual persons, whether a contract of any kind (including a debt contract) is deemed to generate binding obligations may depend on diverse considerations, including the structure of the choice situation faced by the individual, and in particular whether it can be viewed as one that is characterized by sufficient freedom of choice for consent to be inferred.[4] These considerations will also be pertinent to determining whether the contractual arrangements entered into by states ought to be deemed similarly binding for deontological reasons.

Unlike individuals, states cannot, generally speaking, be described as having a temporally bounded existence. It is widely accepted that individuals' net debt obligations—that is, debts that fully exhaust the value of an estate—cannot legitimately be intergenerationally transferred, for example, from parents to children. There is no parallel principle in relation to states. Indeed, it does not make semantic sense to present such a principle since states are not generally conceived as having a temporally bounded existence. Of course, firms are also not generally conceived as having a temporally bounded existence. The implications of this observation for the identification of obligations (in particular for those that are deontological in nature), however, may be different for firms and for states.

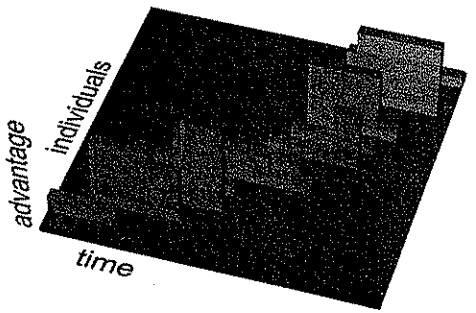
In the case of firms, claims upon net assets and liabilities (established through ownership, management, and employment) change primarily on the basis of explicit contractual agreement between the parties. The set of persons who live within the boundaries of a state, who are citizens of a state, who are beneficiaries of the state's actions, and who are taxed or otherwise imposed upon by the state, may also change over time, and socially recognized implicit or explicit claims upon net assets and liabilities change accordingly. Explicit contractual agreement may not always be involved in such change, however.

It is critical to recognize the complexity of moral assessment in such a setting. Consider Figure 1, which represents lives lived in a country over a period of time. The horizontal axis represents time. Each discrete value along the vertical axis represents a distinct individual, and each bar represents the life lived by that person. Each life has its own starting point and duration. This diagram therefore represents overlapping cohorts in a population and represents the fact that persons are born at different times and die at different times. The members of each cohort, although they are born at the same time, may live different lengths of time. Of course, this diagram only represents a slice of time. People live and die before and after the period represented here. Of course, the number of individuals living in a typical country is vastly greater than such a diagram allows us to represent.

On this diagram, the points at which people are born and the points at which they die are represented. The level of well-being of each person—the overall level of advantage or disadvantage—experienced by each individual at each moment in time is also represented in the diagram. The third axis (coming out of the page) of the diagram represents the level of advantage or disadvantage experienced by a person at a moment in time. The resulting diagram represents the lives lived (encompassing life spans and advantages experienced by each person at each moment in time during those life spans) of the members of the society.

Now imagine that the society to which all of these persons belong enters into a debt contract. The immediate consequence of this debt contract is that resources are made available, and that they can then be spent.

FIGURE 1:
LIVES LIVED

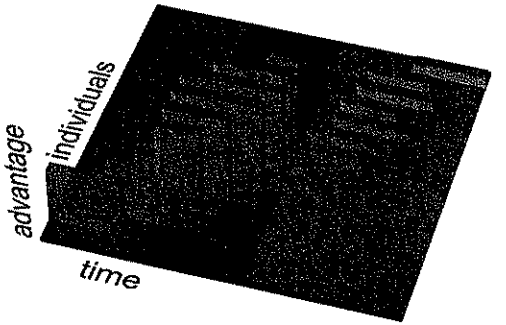


How the resources are spent will determine the level of advantage experienced by different persons at each point thenceforth. Of course, repayment obligations will eventually be incurred, which will cause subsequent decreases in advantage (relative to the counterfactual in which there are no such repayment obligations) at some point in the future. The burdens induced by repayment will be allocated across persons in accordance with social, political, and institutional factors, such as the features of the taxation and fiscal expenditure systems. In figure 2, this pattern is represented graphically, for an arbitrary case.

It is important to note that when the debt contract is entered into, some people may have already been alive for longer periods of time than others, so a larger proportion of their lives may have already elapsed. Additionally, even if two persons were born in the same age cohort and have already lived the same length of time, the length of time they can expect to live subsequently may differ. The reasons for this are diverse and may have to do with systematic variations in the advantages or disadvantages experienced by different groups of people as well as idiosyncratic factors associated with individual health.

When a state enters into a debt contract, therefore, the extent to which different individuals will benefit from the resources that are garnered through undertaking a debt, and the extent to which different individuals will bear the ultimate obligations of repayment, will differ because of variation in the timing of individual lives and variation in the extent to which, at each moment in time, individual persons experience increased advantage as a result of the resources

FIGURE 2:
LIVES LIVED AND DEBT CONTRACTS



collectively garnered or experience decreased advantage as a result of the collective repayment obligations incurred.

An issue which is worth mentioning, although it is bewilderingly complex, is that the number of persons and the identities of the persons who are alive are likely to be endogenous—that is, determined by the amount of debt contracted and the manner in which that debt is both spent and repaid. When persons' lives begin and when they end depend in various ways on the availability of material resources and upon private and public decisions concerning the use of these resources. This dependence adds a tremendous amount of complexity to any kind of assessment of the impact of debt, of which one must be at least aware.[5]

A rather simple-minded, purely consequentialist approach to the analysis of alternative public policies which affect the debts accumulated, the use of the resources garnered, and the repayment obligations they impose might simply aggregate the advantages experienced under distinct alternatives from a single point in time onward. Such an approach (for example, a utilitarian approach) might consider different counterfactual policies or rule systems and ask how they affect the sum total of advantages experienced by all persons over time, or the mean level of advantage experienced by each person alive, or some other aggregative criterion that is held to be of interest. Even a simple-minded exercise of this kind may be inordinately difficult, however, due to the presence of the various complexities discussed here.

MORAL AND ECONOMIC CONSEQUENCES OF THE DISANALOGY

One way to view the disanalogy between the case of international (sovereign) debt and that of domestic debt is that the former involves a mesh of interpersonal externalities which are both intragenerational and intergenerational in nature. For example, the persons who enter into the debt contract may not be the persons who either benefit from the resources that are garnered thereby or who will bear the burden of repayment within any one age cohort, while future age cohorts that bear the burden of repayment may not be the beneficiaries of resources garnered in the past through debt. At least two preliminary conclusions arise straightforwardly as a consequence of the existence of such externalities.

The first preliminary conclusion is that any attempt to argue on *exclusively* deontological (that is, nonconsequentialist) grounds for a strong obligation for states to abide by international debt contracts is likely to be implausible. The arguments of this kind that pertain to individuals or firms (derivative of those that pertain to individuals) cannot be straightforwardly transferred to states, since doing so would entail attaching deontological obligations to some agents based on the actions of other agents entirely. If one takes the standpoint of normative individualism, as I have argued for doing, then such an ascription is far from immediate.[6]

The second preliminary conclusion is that consequentialist arguments for embedding a strong obligation for states to abide by debt contracts into the international regime are likely to depend on a range of empirical claims. These empirical claims may not always be easy to assess. On the one hand, the recognition and enshrinement of such obligations may make it more likely that certain beneficial consequences (in particular, secure access of states to credit markets) may result. On the other hand, the interpersonal externalities (both intragenerational and intergenerational) that are present in the creation and discharge of sovereign debt may give rise to inefficiencies and inequities that could be diminished under other rules.

The pervasiveness of the externalities that are involved is at the heart of contemporary debates. The externalities can be of many kinds, and can have important implications for our judgments of the moral acceptability of the outcomes that are likely to result, whether we adopt consequentialist or deontological evaluative perspectives.

Consequentialist Assessment

The existing rules regulating sovereign debt often make it possible for individuals to enter into contracts that cause *other* individuals to be assigned the obligation to repay. The alignment of incentives in a structure of this kind is very poor, as those who decide whether to borrow and who benefit from borrowing may not pay the full cost of doing so. The result is often an inefficiently large amount of debt.[7] The resulting distribution of burdens may also be inequitable. From this perspective, the existing rules concerning sovereign debt cannot be considered the unique embodiment of principles required to be adhered to in order to bring about an efficient outcome. Indeed, they may even be at odds with such principles. In standard general equilibrium theory, there are no states; there are only individuals. If it is possible for certain individuals or groups of individuals to enter into contracts which impose costs on other individuals, then inefficient

outcomes will result. In order to attain efficient outcomes, it is necessary to put in place rules which enable these externalities to be internalized. If that is not possible, then the best possible—"constrained optimal"—rule systems will be those which balance the inefficiencies arising from such externalities against other goals, such as ensuring that poorer countries have adequate access to international credit markets. In either case, there will also be reasons to favor rule systems that have desirable *distributional* properties—helping to achieve a more desired distribution of advantages within and between age cohorts—in addition to minimizing inefficiency.

Deontological Assessment

As noted above, present rules governing the accumulation and discharge of sovereign debt may be difficult to rationalize in the presence of certain kinds of interpersonal externalities. The recent debate on odious debt—in which governments subsequently deemed illegitimate take on debt and employ the resources garnered for purposes that later seem inappropriate or ill-advised—is best understood in this light. It is difficult to argue for deontological obligations to repay debt according to an inflexible schedule in the presence of such externalities. For deontological obligations to repay to be present despite the existence of intragenerational and intergenerational externalities, it is necessary to argue either that individuals incur obligations as a result of their being bound by a collective decision-making apparatus to which they implicitly or explicitly consent and which has the power to give rise to such obligations, or that they have been beneficiaries of the debts incurred by others to an extent sufficient to generate obligations to repay. Although such conditions may sometimes obtain, it is unlikely that they are reliably present in empirical cases. Certainly, the existing international norms concerning the accumulation and discharge of sovereign debt appear not to take explicitly into account the preconditions for such deontological moral obligations to be deemed to exist.

A NEW DIRECTION: CONTINGENT REPAYMENT

It has been argued that the proposition on the moral agency of states—the claim that states are agents capable of incurring and sustaining obligations over time—must be assessed in light of the pervasive intragenerational and intergenerational externalities that arise in this domain, and that an exclusively deontological account is unlikely to provide a fully satisfactory perspective concerning the

conditions under which states possess moral obligations to fulfill prior debt contracts. In order to arrive at a morally justifiable theory of sovereign debt, or of the kinds of obligations that could be incurred by states generally, it is necessary to permit consequentialist criteria to also play an important role in the assessment.

The stereotypical core feature of a traditional debt contract is that it gives rise to a fixed schedule of repayment obligations. Those repayment obligations are not circumstance- or process-contingent, by which I mean that they do not depend on the states of the world that ultimately arise or the specific actions and events that have given rise to these states. Contracts that provide for repayments to vary contingently with the circumstances that arise and the actions or events giving rise to those circumstances, or with subsequent revelations about prior circumstances and the actions or events that gave rise to those circumstances, would be at variance with this norm. Arguably, they would not be *debt* contracts at all, but rather should be described as contingent claims instruments. I will not refer to such contracts as modified debt contracts, however, putting aside this terminological issue.

Can modified debt contracts be structured so as to address partially the concerns that I have raised? A preliminary observation is that, from a general equilibrium theory standpoint, a world in which it is not possible to enter into state-contingent contracts will generally give rise to inferior outcomes as compared to a world in which it is possible to enter into such circumstance- and process-contingent contracts. Its outcomes can be improved upon (in the Paretian sense) through the introduction of circumstance- and process-contingent contracts.[8] Such contracts can provide for a more efficient distribution of risks. For example, under such contracts, if a very "bad" state of the world (from the standpoint of the debtor) arises, then the rate of repayment can be suitably reduced, and if a very "good" state of the world arises, the rate of repayment can be suitably increased, rather than demanding an inflexible and rigid repayment schedule. Debtors may be willing to pay higher rates of return to creditors in good states of the world in return for the privilege of paying less in bad states of the world, and this may also be attractive to creditors. This Paretian rationale for the introduction of contingent repayment schemes does not require sophisticated moral reasoning. It may be arrived at purely on the basis of conventional welfarist economic considerations, even in the absence of distributional judgments or nonwelfarist moral considerations.[9] The introduction of these additional moral

perspectives, however, can certainly make it possible to arrive at more specific conclusions than might otherwise be attainable.

Quite apart from efficiency considerations, the introduction of circumstance- and process-contingent modified debt instruments may make it possible to align better the sovereign debt repayment obligations formally ascribed to nations under law with understandings of the circumstances under which it is morally justifiable to demand payments. In the next section, I will describe some concrete examples of how this can be done. It will be important to note that in doing so I am in no way challenging the legal slogan *pacta sunt servanda*; rather, I am calling for the introduction of contractual forms (or changes to the background understanding governing contracts) which will permit this slogan to be more comprehensively adhered to in practice—by limiting the need for ad hoc debt restructuring and default while giving rise to outcomes that are more morally justifiable than those often brought about by the demand for adherence to an inflexible schedule of debt payments.

It may be objected that circumstance- and process-contingent contracts of the kind I explore here are often equivalent to contracts which "bundle" together traditional debt contracts and insurance contracts or state-of-the-world contingent securities. From this standpoint, there is nothing that can be achieved by modifying the traditional debt contract that cannot be achieved by combining a traditional debt contract with a suitable state-of-the-world contingent security. Although this is true under abstract conditions, in practice there are missing markets for such securities, in part for the very reasons that state-contingent modified debt contracts are rarely observed in practice. The demand for such securities may be insufficient to bring such markets into existence for various reasons, including the existence of the intrapersonal and interpersonal externalities that make such securities morally desirable—these externalities may limit the interest of decision-makers in hedging against risks of future adverse macroeconomic outcomes (which may beset *other* persons in the same or a subsequent generation), or in otherwise entering into contracts which include forms of circumstance and process contingency. The apparent relative absence of macroeconomic mechanisms for insurance against variations in public revenue and national income has been widely noted.[10] It is partly due to this absence that recurring debt crises, brought about by adverse macroeconomic events (such as commodity price shocks and interest rate shocks), the possibility of which may have been reasonably anticipated, appear to be an endemic feature of the

international economy. Of course, if this problem of missing markets could be corrected, the need for modified debt contracts incorporating contingent repayment might correspondingly diminish. That recognition creates no embarrassment for the argument made here.

POSSIBLE CRITERIA FOR CONTINGENT REPAYMENT

Modified sovereign debt contracts might permit repayment obligations to be made contingent upon both states of the world and the actions or events giving rise to those states of the world. The possible role of such modified debt contracts is best illuminated through a few (far from jointly exhaustive) concrete examples.

Factors Affecting Revenue and Payments

Modified sovereign debt contracts can in principle allow repayments to be made contingent on factors that influence the foreign exchange revenue of countries and their foreign payment obligations. Such factors are often proximately linked to the occurrence of payments difficulties.

A historical case of some importance is offered by the widespread and deep developing country debt crisis that arose in the early 1980s. It is widely thought that the conjunction of a number of distinct factors was responsible for the occurrence and timing of the debt crisis and that these factors included the sharp increase in world interest rates in the early 1980s, significantly linked to measures taken by the U.S. Federal Reserve Board with the apparent intent of reducing U.S. inflation.[11] Although the Federal Reserve acted with the apparent goal of furthering domestic U.S. interests (perhaps especially those of the creditor class in the United States, which was threatened with losses due to unexpectedly high U.S. dollar inflation), there was a broader consequence—creditors in the United States and other developed countries were exposed to the risk of default on the part of developing country debtors who found that it was extremely expensive for them to refinance their debt at the new, higher interest rates. This was an instance in which the group of creditors (or an institution associated closely with them) was at least partially responsible, it may be plausibly argued, for the problems of the debtors. In a situation of this kind, it seems difficult to make a strong moral argument that the payments required of debtors should have been inflexibly held to a previously agreed schedule.

Another reason for the occurrence of the debt crisis in the 1980s was that the prices of many primary commodities exports had become low by historical

standards—a development which had not been adequately anticipated. Modified debt contracts can in principle be made contingent upon such prices. There are some existing examples of debt contracts incorporating such contingency. Contracts for capital services in Islamic banking are precisely of this kind. Perhaps more relevant to this discussion is the use by Nigeria since 1992 of "oil warrants," which are warrants attached to Nigerian government bonds that require the government to make payments to the warrant holder that vary with the current oil price, as well as the prior and similar use by Venezuela of oil-price-indexed obligations.

Basic Requirements of Populations

The extent and nature of the claims that a creditor might make of a debtor could be made to depend on explicitly normative as well as nominally empirical criteria. For example, debt repayment might be made contingent on the ability of the debtor to finance the basic requirements of the population.[12] Similarly, resources garnered through debt and demonstrably expended in the form of investment (with the capacity partially to benefit future generations) might be treated differently from resources which have been used demonstrably to finance present consumption. To the extent that such a demonstration is possible, contracts can be written which permit discrimination between these two cases. In particular, creditors may be held partially responsible for sustained financing of a pattern of expenditure that is unsustainable or morally indefensible.

Odious Debt

There has been considerable discussion in recent years (reviving that initiated by Alexander Sack in the 1920s) of whether certain sovereign debt obligations should be treated as "odious" and accordingly subject to special provisions concerning debtor repayment. For instance, Thomas Pogge, Seema Jayachandran and Michael Kremer, and Jonathan Shafter (the latter in this volume) have separately advocated that the debt contracts entered into by certain kinds of regimes ought not to be viewed as creating a binding repayment obligation on successor regimes.[13] The underlying rationale for such schemes may be viewed as having both consequentialist and deontological components. Illegitimate regimes may be more likely to spend resources in a manner that not only fails to benefit their populations but also lacks the capacity to create morally binding obligations on behalf of their citizens. A framework of international law that recognizes such a

principle is one that implicitly makes debt repayment obligations contingent on whether past states of the world (in particular those in which debt was contracted and refinanced) have possessed specific features (such as debtor regimes that were nondictatorial).

FEASIBILITY CONCERNS

Contingent claims instruments, which condition the amount of repayment on the state of the world that arises and on the manner in which that state of the world arose, will require a system of legal definitions of relevant contingencies, a system of monitoring these contingencies, and third-party arbitration or other mechanisms of adjudication. In recent years, the impressive expansion of derivatives markets has demonstrated that the definition and monitoring of contingencies of diverse kinds is feasible if there is sufficient interest in these activities.[14]

An analysis of the incentives generated by the existence of, and participation in, contingent debt contracts must be at the core of any analysis of their likely effects. An argument that might be advanced against such contingent claims instruments is that they would cause an increase in the perceived—and, indeed, actual—risk of lending to developing countries as well as attendant increases in interest rates and other barriers to borrowing, potentially shutting countries out from the credit market and diminishing their ability to finance their development programs. It is crucial here to consider whether these modified debt contracts would be introduced as alternatives (alongside traditional debt contracts) or as part of a revised background framework of international legal norms. If the former, then this worry need not be of great concern, since countries that would face large increases in interest rates could opt out of modified debt contracts in favor of conventional ones. If the latter, then there is reason for concern. The former approach is unlikely to be wholly satisfactory, as countries may well choose conventional debt contracts precisely as a result of the presence of the intragenerational and intergenerational externalities that we have identified above, which may centrally influence decisions as to whether to take on debt, how much debt to take on, and how to spend the resources thus garnered. Some incorporation of norms concerning contingent claims into the background framework of international law appears to be indispensable. This is, after all, the argument of those who have favored the introduction of odious debt provisions in the international legal arena. Similar arguments may apply to other instances

in which contingent claims may be morally desirable. It is important to see that the argument that the introduction of such norms may raise the costs of borrowing for certain countries, although pertinent, cannot be decisive.

A central issue here is that of the scope of informational externalities. For example, if it is not possible to distinguish between countries that are likely to use the resources garnered through international debt in a "presentist" manner to finance current consumption (perhaps of a small elite) and countries that are likely to use those resources in an investment-oriented manner that benefits future generations, then both kinds of country may face higher interest rates because of the perceived and actual risk that contingent repayment provisions will lead to creditors forfeiting at least some repayment in at least some cases. Potential good borrowers would be deprived of resources which could benefit present and future generations in those countries. This is a nontrivial problem which has to be dealt with, as ex post inefficiencies will result if it is not possible to separate these cases.

One kind of solution which could be considered involves mechanisms for countries to identify themselves as of a specific type through provisions that assure transparency and make monitoring feasible. Such provisions already exist in limited form in the International Monetary Fund's surveillance of countries' macroeconomic situation and the reporting requirements implicitly imposed by private credit rating agencies. The IMF's Policy Signaling Instrument offers countries the ability to undergo IMF conditionalities and surveillance purely in order to demonstrate to the private markets that they possess good policies and provides them with the IMF seal of approval without providing a line of credit or additional resources. This is an interesting example of a mechanism through which countries seek to ensure that they are pursuing sound macroeconomic policies in order to attract credit and investment on favorable terms.[15] It is not difficult to imagine the broadening of monitoring instruments of this kind to encompass the (morally and economically salient) information required. Mechanisms that employ third-party certification to ensure that basic labor standards have been adhered to in the production process present another example.[16] In any event, this issue is unlikely to be of great relevance to the poorest countries, most of which at present are not deemed sufficiently creditworthy to borrow on private international credit markets, and which borrow almost exclusively from official lenders. Official lenders can *choose* to provide borrowers credit at interest rates that they themselves determine.

Of course, changes to the background interpretative framework of international legal norms to permit contingent repayment will not be an unalloyed good either for debtors or for creditors. For debtors, such changes entail limitations on the prerogative of states to borrow at will and for any purpose that they wish, regardless of their regime type. For creditors, they entail limitations on the presumption of repayment according to an inflexible schedule, regardless of who is the recipient of a loan, for what purposes it was spent, and the actions undertaken by different actors or the circumstances that have arisen in the world. Changes to the interpretative framework of international legal norms in this direction entail greater risk sharing between debtors and creditors, as well as the sharing of responsibility for the attainment of normative ends. To advocate this incremental shift in the direction of the sharing of risk and responsibility is not in itself intended to authorize either an infringement on legitimate prerogatives of sovereignty or on such rights to property as may be deemed to exist, but rather to recognize the complexities that enter into the ascription of moral obligations to states. Such sharing of risk and responsibility entails in many instances nothing more than a codification of existing ad hoc practices in regard to debt relief and the abrogation of responsibilities by successor regimes.

The animating force for the exploration of possible institutional alternatives to the current system of stereotyped debt contracts stems from the observation that existing norms concerning the accumulation and discharge of debt by countries give rise to inflexible demands to repay which are often difficult to rationalize morally—and therefore difficult to accept.

NOTES

[1] I do not comment on the question of how these intertemporal threads should be conceived, e.g., in terms of invariance of personal identity or of psychological connectedness and continuity (on which see Derek Parfit, *Reasons and Persons* [Oxford: Oxford University Press, 1984]).

[2] I make the conventional distinction between deontological (i.e., process-related) and consequentialist (i.e., outcome-related) moral considerations for purposes of convenience. In doing so, I do not take a view on whether moral considerations conventionally viewed as deontological can in fact be viewed in terms of consequential evaluation within a framework that is adequately rich (as argued, for instance, in Amartya Sen, "Consequential Efficacy and Practical Reason," *Journal of Philosophy* 97, no. 9 [2000]).

[3] Whether a specific instance of derogation from the formal provisions of a contract should be viewed as an "exemption" (as contrasted with an implicit clause of the contract) may depend on the extent to which it is part of the common background understanding of the contracting parties. For instance, the possibility that a domestic debt contract may be made subject to the provisions of bankruptcy law may be thought to be part of the common background understanding of the contracting parties, and thus to constitute an implicit provision of the contract rather than an exemption.

[4] The determination of whether the freedom of choice is present may depend on diverse considerations, including the availability of distinct alternatives, the ability to choose for oneself among the distinct alternatives, and the nature of the alternatives themselves. See the distinction between the freedom to choose and choosing freely in G. A. Cohen, "Why Do Workers Choose Hazardous Jobs?" in *History,*

Labour, and Freedom: Themes from Marx (Oxford: Oxford University Press, 1989); and the discussion of procedural and substantive freedom in the context of international agreements contained in Christian Barry and Sanjay Reddy, *International Trade and Labor Standards: A Proposal for Linkage* (New York: Columbia University Press, forthcoming).

5 There is an extensive literature addressing pertinent issues under the name of the "nonidentity problem." See, in particular, Parfit, *Reasons and Persons*.

6 It has been proposed that there are such instances, e.g., when the individuals to whom obligations are being attached participate in a shared framework of collective decision-making that meets particular tests (such as implicit or explicit consent to the decision-making structure itself) or when they are beneficiaries of an action taken by others. See, for instance, David Miller, "Holding Nations Responsible," *Ethics* 114, no. 1 (2004), pp. 240–68. It is important to note that such attribution requires, at the least, special preconditions.

7 The inefficiency arises from the fact that lower borrowing combined with appropriate transfers of income between persons could in principle bring about a Pareto improvement.

8 See Andreu Mas-Colell, Michael D. Whinston, and Jerry R. Green, *Microeconomic Theory* (Oxford: Oxford University Press, 1995), ch. 19 ("General Equilibrium Under Uncertainty"), and the broader literature on Arrow-Debreu securities and related concepts.

9 I employ the term "welfarist" to refer to a focus on subjective preference satisfactions as the sole informational basis for evaluation.

10 See Robert J. Shiller, *Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks* (Oxford: Oxford University Press, 1993); and Robert J. Shiller, *The New Financial Order: Risk in the 21st Century* (Princeton: Princeton University Press, 2003). See also Sanjay Reddy, "Safety Nets for the Poor: A Missing International Dimension?" in Giovanni Andrea Cornia, ed., *Pro-Poor Macroeconomics: Potential and Limitations* (New York: Palgrave Macmillan, 2006).

11 See Harold James, *International Monetary Cooperation Since Bretton Woods* (Oxford: Oxford University Press, 1996), on the debt crisis. More generally on the early 1980s as a period of high world real interest rates, see Menzie Chinn and Jeffrey Frankel, "The Euro Area and World Interest Rates," Santa Cruz Center for International Economics Working Paper Series 1016 (Center for International Economics, University of California at Santa Cruz, November 2003); available at ideas.repec.org/p/cdl/scciec/1016.html; and Jong Eun Lee, "On the Characterisation of the World Real Interest Rate," *World Economy* 25, no. 2 (2002), pp. 247–55.

12 Kunibert Raffer (in this volume) has argued for the recognition of principles in international law that provide for the legitimate interests of creditors to be balanced against such basic interests of populations during debt workouts.

13 Thomas Pogge, *World Poverty and Human Rights* (Cambridge: Polity Press, 2002); and Seema Jayachandran and Michael Kremer, "Odious Debt," *American Economic Review* (forthcoming).

14 See also the discussion in the works by Shiller, n. 11.

15 It should not be necessary to underline that in providing the example of the IMF's Policy Signaling Instrument I am not suggesting either that it is in itself attractive or that the IMF would be the appropriate agency to do such monitoring more generally. For a description of the Policy Signaling Instrument, see International Monetary Fund, "The Policy Support Instrument: A Factsheet" (August 2006); available at www.imf.org/external/np/exr/facts/psi.htm.

16 See National Research Council, *Monitoring International Labor Standards: Techniques and Sources of Information* (Washington, D.C.: National Academy of Sciences, 2004), esp. ch. 3, "Information from Nongovernmental Labor Monitoring Systems."

The Due Diligence Model: A New Approach to the Problem of Odious Debts

*Jonathan Shafter**

Odious debt is sovereign debt incurred by a government lacking popular consent, utilized for no legitimate public purpose. This specific subset of sovereign debt is separate from such issues as unsustainable debts incurred by democratic or quasi-democratic developing countries, or debts incurred by nondemocratic regimes for legitimate public ends. This paper is concerned with the narrow problem of money borrowed by dictators from foreign creditors that is then either spent on illegitimate ends, such as repressing the country's population, or simply looted and deposited into the private offshore bank accounts of the ruling class. Many legal scholars advocate that international law grants successor regimes permission to repudiate inherited debts meeting the odious debt standard. Whether international law theoretically does or does not provide for such a remedy, however, the fact remains that for practical purposes successor governments to illegitimate regimes do not invoke the odious debt doctrine, out of fear that doing so would deprive them of necessary access to global credit markets.

Odious debt is a moral issue, as it is manifestly unfair to demand that a population repay what are basically the personal debts of its former captors—loans that were in many cases used to actually fund the machinery of public repression. But beyond purely ethical considerations, there are significant prudential reasons for the international community to reform the treatment of odious debts. Successor governments to fallen dictatorial regimes are often placed in the position of rebuilding a shattered nation with scarce resources. This scarcity is severely compounded when the meager resources of a successor government are diverted toward servicing the odious debts of the prior regime rather than invested in constructing a secure and sustainable platform for national development.

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