ODIOUS DEBT OR ESG: CURTAILING THE ACCESS TO DEBT MARKETS FOR DESPOTS

Policy Brief n°3 – September 2022 – Théo Maret

Current geopolitical tensions are spilling over to sovereign debt markets. They raise questions related to technical defaults, willingness versus ability to pay, or currency denomination. At the same time, they sparked renewed interest in research pertaining to the access of despotic regimes to debt markets, specifically the concept known as "odious debt". This underpins the idea that sovereign debt, more than any other financial instrument, is intertwined with political and moral considerations.

WHAT IS THE ODIOUS DEBT DOCTRINE?

Sovereign debt is a specific asset class to the extent that creditors lack enforcement mechanisms when the issuer is not willing to pay them back, notwithstanding protracted litigations for instruments governed by foreign law with highly uncertain results. Even a favorable judgement can be virtually impossible to enforce, for example by trying to seize some of the issuer's overseas assets – see the literature on sovereign immunity (e.g. Weidemeier, 2014 on recent developments).

In this context, there is ample academic literature trying to understand why sovereigns pay back their debt, e.g. Panizza, Sturzeneger, and Zettelmeyer (2009) find that the incentive for States to repay is tied rather to the domestic cost of default while fears of market exclusion are to some extent unwarranted.

Sovereigns can issue instruments with maturities much longer than the life expectancy of current governments – even perpetuities which appeared as soon as the middle age, issued by the city-states of the Italian Peninsula (Eichengreen, El Ganainy, Esteves and Mitchener, 2019). This owes to the "general rule of state succession" in international public law, stating that new governments or States inherit, among other things, debt issued by their predecessors.

Buchheit, Gulati and Thompson (2007) indicate that the strict application of this rule can lead to "immoral" outcomes, for instance in a transition away from a tyrannic regime which used debt as a mean to oppress its people.

They write: *"Among the purported exceptions to the general rule of state succession are what have been labeled "odious debts," defined in the early twentieth century as debts incurred by a despotic regime that do not benefit the people bound to repay the loans."*

Similarly, Kremer and Jayachandran (2002) write: *"Sovereign debt is odious if (1) its purpose does not benefit the people and (2) it is incurred without the consent of the people"*. Additional to regime changes, this definition would also encompass broader cases such as the coercion of governments into debt contracts by outside entities, public or private.

Enshrining in international public law such an exception to the rule of state succession would in theory (i) avoid a double punishment for populations who already suffered from hardship, and (ii) encourage more thoughtful lending practices, reducing the funding available to dubious regimes.

WHEN HAS THIS CONCEPT BEEN APPLIED?

The concept of odious debt is particularly difficult to apply in real life as it requires a definition as clear-cut as possible of what a despot is. It is unclear what institution, e.g. the UN, or the UN Security Council, would have the power and credibility to use and enforce such a definition. Choi and Posner (2007), stress that many factors force liberal governments to have an ambivalent relationship with dictatorships, involving cooperation on trade, military operations, and even sometimes humanitarian endeavors.

Similarly, Gelpern (2007) finds that the odious debt discussion has been mostly focused on commercial creditors, preventing a debate about bilateral loans which sometimes represent a larger share of outstanding claims on despotic regimes – she cites Iraq, Liberia and Niger.

Buchheit, Gulati and Thompson (2007) note that there has been a slippage over time from the notion of odious debt to that of odious regimes, making such a concept even more difficult to be applied: one cannot look simply at the instrument level, e.g. the use of proceeds of specific bond issuances – which is already tricky with the fungibility of money and budgetary rules.

Additionally, not all debt incurred to finance a war can be considered as odious. Quite the opposite: the growth of sovereign debt issuances was initially driven by the need to support war efforts, and only after 1650 did the motives for public indebtedness transitioned towards the provision of public goods (Eichengreen, El Ganainy, Esteves and Mitchener, 2019). Ukraine provides a more recent example in this regard.

There have been several occurrences of selective repudiation of sovereign debt obligations. It happened oftentimes in a post-colonial context, such as Mexico repudiating in 1861 the borrowings carried out in previous years by another government. Oosterlinck, Panizza, Weidemeier and Gulati (2021) make a case for the Haiti Independence Debt of 1825, imposed by the former French ruler, to be considered as odious – they go further by estimating the economic damages of this debt, amounting to several billion dollars.

The closest the world came to developing an actual odious debt doctrine was Iraq after the 2003 invasion, and the literature on the topic was abundant in subsequent years. One of the most detailed accounts was written by Hinrichsen (2021) – see also his appearance on the Odd Lots podcast. He writes: *"The U.S. spent significant political capital and used close-to unprecedented tools to force*

creditors to exchange debt claims. However, it stopped short of enshrining a doctrine of odious debt in international law, despite initial overtures in that direction. Political expediency was preferred to a new sovereign debt restructuring regime."

Overall Gelpern (2005) shows that there is reluctance from all parties involved – e.g. States, private creditors – to settle on a common doctrine, with a preference for exceptionalism and the flexibility of existing or alternative tools, such as a UN resolution in the case of Iraq. This is in spite of reform proposals – e.g. the Sovereign Debt Restructuring Mechanism (Krueger, 2002) – being milder than some previously used policy instruments.

There have also been more recent examples of governments repudiating – or threatening to repudiate – part or the entirety of the debt incurred by their predecessors. Following his 2008 election in Ecuador, President Correa instructed its administration not to pay an upcoming coupon, saying that the debt was "illegitimate" and bondholders "real monsters", triggering a sovereign default.

In Greece in 2015, the President of the Parliament established a "Truth Committee on Public Debt" which subsequently found out that some of incurred debts were "illegal, illegitimate and odious", including owed to the IMF, the ECB, the EFSF, bilateral and commercial creditors. There was however no subsequent legal action to try and enforce this political decision.

TOWARDS A WORKABLE ALTERNATIVE

Acknowledging the shortfalls of the first-best approach, several academics have made contributions towards a workable alternative to a "full-fledged" odious debt doctrine. For instance, Buchheit, Gulati and Thompson (2007) propose to opt for a second best of focusing on establishing defenses from enforcement through "well-recognized principles of domestic law", such as Considerations of Public Policy, Unclean Hands, and Agency Law.

Hausmann and Panizza (2017) set forward the idea of developing an equivalent of credit ratings for odiousness, based on a scale from "O" (odious) to "W" (well-managed), with intermediate notches depending for example on whether the dictatorship promotes economic development for its population. Such ratings, if included in international soft law, could drive financing costs and prevent debt rampages by despotic governments.

Panizza and Gulati (2018) also proposed building a database of legal infirmities in sovereign debt contracts – such as the lack of parliamentary approval as observed in Venezuela – to pressure investors out of these instruments. Indeed, they observed in discussions with stakeholders that the fear of selective repudiation on legal grounds is an important driver for the behavior of sovereign debt investors. This proposal would be especially relevant to drive prices down on the secondary market, hereby increasing financing costs.

ESG AS A BEDROCK FOR "VIRTUOUS" DEBT MARKETS?

The proposal for sovereign debt odiousness ratings is reminiscent of the recent spike in interest for environmental, social and governance (ESG) considerations in capital markets, with the development of ESG metrics, scores, and ratings. What can be considered as odiousness should at least to some extent fall under the 'S' and 'G' pillars of such ratings, so there is a point to be made in support of ESG investment policies as an alternative to the odious debt doctrine for commercial debt.

Most sovereign debt investors now have ESG policies at the company level, and many have developed specific guidelines with regards to the sovereign asset class. One could be inclined to think that any serious ESG policy would explicitly exclude investing in a country invading a peaceful neighbor, but this is not as straightforward. First, because exclusion is not a requirement of ESG policies, which are often rather based on "best-in-class" approaches and applying relative weights, instead of outright kicking out worst performers.

Moreover, the use of an exclusion approach is especially difficult in the sovereign asset class which remains a comparably small investment universe in terms of the number of issuers, the exclusion of which can have drastic effects. For instance, an investment policy excluding countries applying the death penalty would prevent investors from accessing US Treasuries which constitute the bedrock of today's financial markets.

Additionally, ESG considerations are especially difficult to apply to sovereigns because of the poor quality and standardization of data. Research by the World Bank (Boitreaud et al., 2020) finds that there is an average lag of 5 years for environmental and 3 years for social and governance data in the World Bank's Sovereign ESG Data Portal – a tool widely used by sovereign investors. Similar work by the World Bank (Gratcheva et al., 2021) shows that there is a particularly strong correlation between sovereign ESG ratings and countries' incomes – an "ingrained income bias" – which leads to questions about what sovereign ESG data is measuring concretely.

The rise of passive investing – in sovereign debt like in other asset classes – has further complicated things, as illustrated by the ongoing debates around the exclusion of Russia from sovereign debt indices. Indeed, investors tracking such indices – e.g. through ETFs – cannot make the decision themselves to drop specific securities, a decision which falls entirely on the shoulders of the index provider.

For example, most index providers have decided to exclude Russian bonds from their emerging markets indices following the invasion of Ukraine, some following extensive discussions and surveys with clients. While it became clear that indices had become "unreplicable" by passive investors due to sanctions, analysts had also indicated that kicking out the bonds would simply increase the tracking error of current investors, which are unable to liquidate their position – see e.g. Matt Levine's piece on "uninvestable markets".

A useful precedent we can look at is Venezuela in 2019: as reported by Reuters at that time, the phase out lasted four months and the exclusion of the Venezuelan bonds from JP Morgan's emerging markets indices decreased the average yield by a significant 45 basis points.

It hence seems like until now the decision to exclude potentially odious bonds from indices is mainly driven not by any notion of ESG or odiousness, and rather by technical and financial return considerations. However, the latest policy developments related to sustainable finance are forcing market participants to dedicate resources towards the integration of ESG, which might support the development of more standardized and relevant methodologies.

While the narrative had been centered in recent years on climate with strong momentum around the development of green taxonomies across the board, current geopolitical tensions could trigger a welcome reckoning moment on the role of sovereign debt investors in propping up dubious regimes. This reckoning would obviously be facilitated by a significant increase – or the perception thereof by market participants – of reputational and litigation risks as stressed by Panizza and Gulati (2018).

CONCLUSION

It is morally just to try and curtail the access of despots to debt financing, but the odious debt doctrine is no silver lining. If applicable, it would remain a distant threat materializing mostly long after pain has been inflicted on populations and there is a regime change. Absent any reform of the international financial architecture for sovereign debt restructurings, it would also depend on the discretionary support of other States and multilateral bodies.

It remains to be seen if during this crisis, as opposed to Iraq and others, Western countries will try and forge a long-lasting solution as regards exceptions to the general rule of state succession, bridging a gap in the international financial architecture which rarely materializes but with potential dramatic consequences for populations. If the G20 Common Framework for Debt Treatment and its difficult implementation provide any insights, there is still a lot of diplomatic heavy lifting to be done before we see any concrete progress.

However, current circumstances, as well as evolutions in global sustainability policy objectives may lead to a richer approach to the evaluation of sovereign debt in capital markets through ESG indicators. These can become especially relevant if we undergo a clarification between their role as inputs or outputs of investments decisions – underpinning the limits of the "do well by doing good" discourse prevalent with the development of ESG in capital markets.

This policy brief was written by Théo Maret, Research Assistant. For more content, please visit the blog of Sciences Po's Chair in Sovereign debt.

SOURCES

Sovereign Immunity And Sovereign Debt; Weidemeier, 2014

The Economics and Law of Sovereign Debt and Default; Panizza, Sturzeneger, Zettelmeyer, 2009

Public Debt Through the Ages, in "Sovereign Debt, a Guide for Economists and Practitioners"; Eichengreen, El Ganainy, Esteves and Mitchener, 2019

The Dilemma of Odious Debts; Buchheit, Gulati, Thompson, 2007

Odious Debt; Kremer, Jayachandran, 2002

A Critique of the Odious Debt Doctrine; Choi, Posner, 2007

Odious, not Debt; Gelpern, 2007

The Odious Haitian Independence Debt; Oosterlinck, Panizza, Weidemeier, Gulati, 2021

The Iraq sovereign debt restructuring, Simon Hinrichsen, 2021

What Iraq and Argentina Might Learn from Each Other; Gelpern, 2005

A New Approach To Sovereign Debt Restructuring; Krueger, 2002

Putin's approval has stayed strong over the years – war in Ukraine could change that; Buckley, 2022

Odiousness Ratings for Public Debt; Panizza, Hausmann, 2017

The Hausmann-Gorky Effect; Gulati, Panizza, 2018

Riding the Wave: Navigating the ESG Landscape for Sovereign Debt Managers; Boitreaud, Gratcheva, Gurhy, Paladines, Skarnulis, 2020

A New Dawn : Rethinking Sovereign ESG; Gratcheva, Gurhy, Emery, Wang, Oganes, Linzie, Harvey, Marney, Murray, Rink, 2021

THE CHAIR IN SOVEREIGN DEBT

The Sciences Po Chair in Sovereign Debt aims to provide leading expertise on government finance, constituting a unique academic reference point on public debt issues. The Chair was inaugurated in November 2019. Attached to the Paris School of International Affairs at Sciences Po.

The Chair is governed by a scientific committee and a steering committee, and is funded by a unique sponsor, Global Sovereign Advisory.