Odious Debt[*]

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Abstract

Many argue that trade sanctions are ineffective because they generate incentives for evasion. Others object to them as hurting the population of the target country as well as its leaders. We argue that loan sanctions, unlike trade sanctions, may be self-enforcing and that they may help the population even disregarding their role in changing regime behavior. If governments changed the law to prevent seizure of countries' assets to repay illegitimate loans, then creditors would have little incentive to lend to dictators. This would protect the population from being saddled with debt run up by dictators to finance looting or repression. However, rulings on whether debt is odious made *ex post* would be subject to bias if the deciding body asymmetrically valued the welfare of debtor countries and their creditors. Restricting such declarations to cover only *future* lending would help avoid this time-consistency problem.

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1. Introduction

Trade sanctions against dictators are often ineffective because third parties have incentives to break them. Even when trade sanctions bite, they can hurt not only the dictator, but also the people living under him. This paper argues that loan sanctions—limiting dictators' ability to borrow—would be less subject to these problems. Specifically, countries could announce that any future debt incurred by a dictator would be considered illegitimate and non-transferable to successor regimes. They could implement legal changes to prevent assets of the successor regime from being seized to enforce repayment of the debts. These measures could eliminate equilibria with illegitimate lending.

Both trade and loan sanctions may hurt the population in the short run if the country's economic surplus shrinks and, with it, the amount that accrues to the people. Loan sanctions, though, come with an additional long-run benefit for the population, namely they prevent it from being saddled with debts run up by the dictator. For plausible parameter values, the short run costs of loan sanctions are likely outweighed by the longer-run benefits to the population.

Our analysis is related to the legal doctrine of *odious debt*, which holds that debt should not be transferable to successor regimes if (1) it was incurred without the consent of the people and (2) was not for their benefit [Sack, 1927; Feilchenfeld, 1931].[1] The underlying principle is that just as an individual does not have to repay money that someone fraudulently borrows in her name and a corporation is not liable for contracts that its chief executive officer enters into without authority to bind the firm, governments should not be responsible for illegitimately contracted debt. The doctrine arose after the Spanish-American War, when the United States contended that

[1] Other work on odious debt includes Adams (1991) and Hanlon (2002) who argue the case that much developing-country debt is illegitimate, and Ashfaq et al (2002) who discuss related legal issues. Pogge (2001) proposes that a panel assess the democratic status of governments in order to deter lending to autocratic regimes. We differ from previous work in discussing the multiple equilibria of the debt market, the deterrence of lending to dictators through elimination of creditors' incentives to issue these loans, and the tradeoffs between *ex ante* and *ex post* rulings.

neither the U.S. nor Cuba should be responsible for debt that Cuba's colonial rulers had run up in Cuba's name. The concept has attracted considerable attention recently as a range of commentators, from the editors of the *Wall Street Journal* and *National Review* to Joseph Stiglitz, as well as senior U.S. policymakers such as Iraqi envoy Paul Bremer and Treasury Secretary John Snow have made statements suggesting that the debt incurred under Saddam Hussein should perhaps be considered odious and not the new Iraqi government's obligation to repay.[2]

Yet the doctrine of odious debt remains a minority view among legal scholars, and U.S. policymakers no longer emphasize this rationale when arguing for debt relief for Iraq. This is largely out of concern that the concept of odious debt could prove a slippery slope. Countries could claim that previous debt was odious as an excuse to not repay legitimate debt. More generally, any adjudicating body that had the power to declare debt void *ex post* might nullify legitimate debt if it placed a high value on the welfare of the debtor country. If creditors anticipated being unable to collect on legitimate loans, the debt market would shut down.

We argue that rulings on the odiousness of *future* loans to a particular government would be less subject to this time-consistency problem than rulings on existing debt.

Loan sanctions would be effective in a limited number of cases since many dictators run their country into the ground economically and cannot borrow in any case. Others, probably including Iraq during the time of Saddam Hussein's borrowing, would be protected from sanctions by the major powers. However, in some cases, loan sanctions could have been a potent addition to the international community's toolkit of sanctions. For example, in 1985 the United Nations Security Council imposed trade sanctions on the apartheid regime in South Africa, but the regime

[2] *Wall Street Journal*, April 30, 2003; "Iraq: Worth Every Penny - President Bush's request for $87 billion for Iraq," *National Review*, October 27, 2003; "Odious Rulers, Odious Debts, " *Atlantic Monthly,* November 2003; U.S. House International Relations Committee Hearing on U.S. Policy Toward Iraq, September 25, 2003; U.S. Senate Armed Services Committee Hearing on Operations and Reconstruction in Iraq, September 25, 2003; "Iraq Needs a New Currency and Debt Relief," Bloomberg News., April, 11 2003.

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continued to borrow from private banks through the 1980's. Or, in 1997 when Franjo Tudjman of Croatia had instigated violence against political opponents and looted public funds, the major powers cut off IMF lending to Croatia. Commercial banks nonetheless lent an additional $2 billion to the Tudjman government before his death in 1999. If major players in the international community had publicly declared that they would regard any additional loans to apartheid South Africa or Tudjman's regime as odious, creditors might not have granted the subsequent loans, and the populations would not bear the debt today.

The efficacy of loan sanctions may be a double-edged sword, however. Loan sanctions, compared to other measures used today, may be easier for a one or a few major powers to apply unilaterally. It might be in several countries' interests to develop checks and balances that could limit the use of loans sanctions to cases in which international consensus exists.

The remainder of the paper is organized as follows. Section 2 presents the model and discusses equilibria in the absence of either loan or trade sanctions. Section 3 compares loan and trade sanctions. Section 4 argues that rulings on the legitimacy of future loans would be less subject to bias than rulings on existing debt. Section 5 concludes.

2. Model of Sovereign Debt and Odious Regimes

We embed the analysis of odious debt in a standard reputational model of borrowing. Bulow and Rogoff (1989) show that in reputational models of sovereign borrowing, it is necessary that the borrowing country not have access to a savings technology. Otherwise there would be some point at which the country would better off reneging on its debt, saving the funds that would have been used to repay the debt, and using the funds to smooth its consumption in the future. Our assumption is that there is no domestic storage technology. (In practice, domestic investments may be less attractive than diversifying internationally.) We assume that a foreign savings technology

exists but is typically not a viable option for a defaulting country, since foreign governments allow creditors who are owed money by the defaulter to seize the savings, as we discuss below.[3]

2.1 Setup of the model

Production: We consider a country existing in discrete periods from time t=1 to t=∞. The country has a population whose size is normalized to 1. The government allocates the population's labor between harvesting fruit and building palaces. Fruit production is $A(t)L_F(t)$ if harvesters are paid at least $w \geq \underline{w}$; if $w < \underline{w}$ the harvesters are too sick to work. A(t), the productivity stream, is uneven. For 50% of countries, A(t) = a if t if is odd and A(t) = A > a if t is even. For the other countries, A(t) = A if t if is odd and A(t) = a if t is even. This unevenness generates a reason for either borrowing or saving, namely to smooth consumption. We will focus on countries where the first-period productivity is low: such countries will prefer to borrow in period 1 and continue with a pattern of borrowing in odd periods with repayment in even periods. We assume $a > \underline{w}$ to ensure that fruit production is sufficient to support harvesting even in bad years. The rest of the labor force $L_P(t)$ is allocated to palace production. Building palaces requires well-fed workers who can maintain their concentration. It also requires imported marble whose price is P_M. Palaces are produced discretely. Production is $int(\min\{L_P(t)/\mu, M/\mu\})$ if builders are paid at least $w \geq W > \underline{w}$ and 0 otherwise, where M is the amount of marble imported and μ is the amount of labor force and marble needed to build one palace. Fruit is non-storable and can be bought and sold internationally at price 1.

Governments and their objectives: The population has a period utility function $u(\cdot)$ that is concave in consumption of fruit. Its utility is additively separable over time with discount rate β.

[3] In the working paper version, Kremer and Jayachandran (2002), we allow for a domestic savings technology and model debt contracts as supported by linked reputations across markets, following Cole and Kehoe (1996).

The population receives no utility from palaces. The country has a new government each period. A non-odious government maximizes the integral of the population's discounted utility.

In the first period, there is the potential for a dictator to take power. (In the appendix, we present the general case where a dictator can take power in any period.) The would-be dictator faces a utility cost of taking power distributed F(c) where $F(0) > 0$, so that given expected utility from being dictator of V, a dictator takes power with probability F(V). Let $G \in \{$odious, non-odious$\}$ be the government type in period 1, where G = odious whenever a dictator has taken power. Governments are always non-odious in subsequent periods. An odious government maximizes its own utility v(p, f) which is increasing in palace ownership and fruit consumption. We assume preferences for palaces are satiated at one palace so that $v(p,f)=f$ for $p < 1$ and $v(p,f)=\psi+f$ for $p \geq 1$. We also assume $\psi \geq \mu(P_M + W + a - \underline{w})$, or that an odious government's utility from palace ownership outweighs the input costs and foregone fruit production, implying that it constructs a palace if possible.

Note that these assumptions about $v(p,f)$ generate a benefit to the population from an odious government's trading and possibly borrowing. Preventing an odious regime from importing marble deprives part of the population of the wage premium $W-\underline{w}$ associated with palace construction, as does a loan sanction if an odious government needs to borrow to pay for a palace (which is true if $a<\mu(P_M +W)/(1-\mu) + \underline{w}$).

Banks: There are competitive foreign banks that live for two periods and are replenished in odd periods. Banks face a gross world interest rate of $1/\beta$ and can issue loans in all periods. The loan contract is as follows. A bank pays an amount $d(t) \geq 0$ in period t and the country is expected to repay $d(t)R$ in period $t+1$.

We assume that a country can save overseas and earn a gross interest rate of $1/\beta$. However, in period t+1, a bank that loaned d(t) to a country can seize the overseas assets of the borrowing

country up to the amount d(t)R-b(t+1) where b(t+1) is the debt repayment the country made to the bank. In the United States, the Foreign Sovereign Immunities Act of 1976 gives creditors this right by denying sovereign immunity in claims related to commercial activity.[4] Similar laws are in place in most developed countries where debtor countries would consider placing their savings.[5]

Timing: At the outset of period 1, the dictator's takeover cost is realized and the dictator decides whether to take over, determining G. Banks then choose whether to issue a loan $d(t)$ to the government. The government can withdraw any foreign savings it holds. Next, the government chooses a wage for the population and allocates the population's labor. Then simultaneously production occurs, the population receives its wage, the government receives any surplus production, and marble and fruit are bought and sold. Fruit is consumed. The government may make a debt repayment $b(t)$ and deposit savings abroad (that can be seized by a bank owed money by the country if foreign law allows it to do so). Subsequent periods are identical except that the government is always non-odious.

2.2 Equilibria and the status quo of the sovereign debt market

The folk theorem implies there are multiple subgame perfect Nash equilibria of the type of repeated lending game played in this model. In one equilibrium, banks never lend, and if they did, the governments would never repay their loans. In other equilibria, non-odious governments are able to smooth consumption by borrowing in odd-numbered periods and repaying in even periods. Since banks are competitive, the interest rate will be $R=1/\beta$. The government maximizes

[4] The law's applicability to sovereign debt was upheld in the 1992 Supreme Court case of *Republic of Argentina et al.* v. *Weltover.* Argentina issued bonds repayable in New York City among other places. When the bonds) began to mature in May 1986 Argentina extended the time for repayment. Two Panamanian corporations and a Swiss bank brought this breach of contract action to the District Court in New York. The District Court, the Court of Appeals, and then the Supreme Court ruled in the plaintiffs' favor.

[5] For example, the European Convention on State Immunity, the State Immunity Act 1978 of the United Kingdom, and Article 5 of the Draft Articles on Jurisdictional Immunities of States and Their Property of the International Law

$u(a+d(t)) + \beta u(A-d(t)/\beta)$ for odd t, trading off increased consumption at present with decreased consumption in the next period. The solution to the first order condition, $u'(a+d(t))= u'(A-d(t)/\beta)$ defines its optimal odd-period loan amount D^*. Odious governments always borrow as much as possible, since they do not care about future repayment.

The maximum loan that can be supported through reputation, denoted D, is given by $u(A-D/\beta) + \beta u(a+D) \geq u(A)+ \beta u(a)$. The term on the left is the discounted utility for an even period and the next period if the country repays, and the term on the right is if the country defaults and lives in autarky. We assume that $\mu(P_M+W)-(1-\mu)(a-\underline{w})\leq D\leq D^*$ which ensures that governments can borrow enough to satisfy odious governments' desire for palaces.

The status quo of the sovereign debt market seems to be that creditors lend to a government as long as it is creditworthy, and successor governments, concerned about their reputation, accept responsibility for debt, even if the predecessor regime is regarded as odious. For example, Anastasio Somoza was reported to have looted $100 to $500 million from Nicaragua by the time he was overthrown in 1979. Daniel Ortega, leader of the Sandinista government that succeeded Somoza, told the United Nations General Assembly that his government would repudiate Somoza's debt, but he reconsidered when his Cuban allies advised him that doing so would unwisely alienate Nicaragua from Western capitalist countries.[6] Similarly, the South African government, in order to remain in the good graces of investors, has distanced itself from the popular movement to nullify its apartheid-era debts.[7]

Commission, which represents the consensus view in international law, deny state immunity for commercial activity ("acta jure gestionis").

[6] "Somoza Legacy: Plundered Economy" (*Washington Post*, November 30, 1979); "Cuba's Debt Mistakes: A Lesson for Nicaragua" (*Washington Post*, October 5, 1980).

[7] Its top ministers recently denounced a lawsuit seeking reparations from banks that loaned to the apartheid regime because, "we are talking to those very same companies named in the lawsuits about investing in post-apartheid South Africa." See "S. Africa Shuns Apartheid Lawsuits" (*Guardian*, November 27, 2002).

The equilibrium in the model that best describes this status quo is the following. In odd periods t, if previous loans have been repaid, banks lend $d(t)=D$, which is the loan size supported by the maximum penalty that a country would face if it defaulted, to both types of governments. In period 1 if the government is odious, μ workers are employed as palace builders and are paid W, and the remainder harvest fruit and are paid $\underline{w}$. The government consumes a palace and fruit valued at $D+(1-\mu)(a-\underline{w})-\mu(W+P_M)$. If the government is non-odious, all workers harvest fruit and are paid $a+D$ in odd periods. In all even periods, the non-odious government repays existing loans and $A-D/\beta$ is passed along to the people, all of whom harvest fruit.

2.3 Loan sanctions: eliminating equilibria with odious debt

Of course, in addition to the equilibria discussed above with no lending or with maximal lending in odd periods, the folk theorem supports a plethora of other equilibria. There are equilibria where lending occurs if t is an odd prime number. There are also equilibria in which loans are only issued to non-odious governments. One basic explanation for why we are not in such an equilibrium may be that banks and governments have coordinated on the simpler equilibrium where loans do not depend on government type. This coordination may be a reflection of history—in the past, more governments were undemocratic and may have had little interest in international norms that cast doubt on the legitimacy of sovereign governments.

If the international community imposed what we term loan sanctions, equilibria in which odious loans were repaid could be eliminated. Specifically, suppose countries make legal changes that prevent assets from being seized to repay odious debt. A successor government to a dictator who has run up debts would have every incentive to refuse to repay the loans and instead deposit the funds that would have been used to repay the loans in a bank account overseas. The country could then use these funds to smooth its consumption in the future. The loan sanction eliminates

the penalty a country faces for repudiating odious debt and, anticipating this, banks would not issue odious debt in the first place.

2.4 Loan sanctions more broadly construed

We model loan sanctions against odious governments in the context of a very specific model of debt. This choice was partly because this is a canonical model, and partly because it is tractable. Stepping outside the model, one can imagine that loan sanctions might not destroy equilibria with lending to odious governments but simply lead to coordination an equilibrium in which this lending does not take place. Suppose storage technology did not exist overseas. The international community could still declare that it regarded future loans to a particular dictator as odious and would not expect the successor government to repay them. It seems plausible that such an announcement by the US, the European Union, Japan, etc. would cause creditors to change their expectations about being repaid and lending to that dictator would dry up. Even without legal changes, equilibria with odious debt could be eliminated with further steps by the international community. Donors could tie their foreign aid to past announcements and withhold foreign aid from countries that were repaying predecessors' odious debt. In other words, donors could refuse to give aid that the country, in effect, will hand over to creditors who issued odious loans. If the foreign aid were valuable enough, the country would have incentives to repudiate odious debt, and banks, foreseeing this, would not originate such loans.

3. Comparison of Loan and Trade Sanctions

We first discuss how trade sanctions and loan sanctions deter dictators from taking power. We then show that firms have an incentive to break trade sanctions, and that if trade sanctions are enforced, they make the population worse off in the period in which they are enforced. We then

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discuss loan sanctions and argue that they do not suffer from the fragility of trade sanctions. In addition, they have better welfare implications. While loan sanctions may also harmful to the population in the period in which they are enforced, they make the population better off in future periods by reducing the level of debt carried over to the future.

3.1 Deterrent effects of trade sanctions and loan sanctions

In the context of our model, trade sanctions against a country consist of an agreement among all other countries to not allow native marble suppliers to supply marble to the sanctioned country. As discussed above, loan sanctions are actions by countries that change the equilibrium in the sovereign debt market to one in which the sanctioned government receives no loans from private creditors.

The probability of a dictator arising in period 1 is endogenous to the spoils from office. Let υ_s be the probability that the period-1 government is odious where s denotes the sanctions in place, which are announced at the outset of period 1. In equilibria where odious governments can borrow up to an amount D and there are no trade restrictions, $\upsilon_s=F(D+\psi+(1-\mu)(a-\underline{w}) -\mu(P_M+W))$. Recall that $F(\cdot)$ is the cumulative distribution of the dictator's cost to seize power; the argument is his utility, in equilibrium, from being in power. When a trade sanction is in effect, a dictator cannot import marble, so his utility is reduced to D+a-$\underline{w}$ since he cannot build a palace. When a loan sanction is in place, a dictator cannot borrow and his utility is reduced to either $\psi+(1-\mu)(a-\underline{w}) -\mu(P_M+W))$ if he is able to pay for a palace by selling fruit, or to the lower amount a-$\underline{w}$ if he is not able to pay for marble and build a palace without borrowing and allocates all labor to harvesting. When both sanctions are in place, the takeover probability is F(a-$\underline{w}$), where the argument is the dictator's utility from only consuming fruit. In each of these cases, sanctions

reduce the utility a dictator would obtain from being in power and therefore lower the probability that he takes over the country.[8]

3.2 Problems with trade sanctions

One weakness of trade sanctions is that they are relatively fragile. Consider the case in which marble suppliers are Bertrand competitors. If one country with two or more marble suppliers does not agree to the sanctions, the sanctions do not affect the payoffs for the sanctioned government. Furthermore, there may be strong incentives for marble suppliers to break the sanctions, as a single marble supplier supplying to the sanctioned country can extract rents from the odious government, although in this case the sanctions still deter the rise of dictators.

A second problem is that when trade sanctions bind, the population is made worse off. The government is no longer able to build palaces which deprives a portion of the population of the efficiency wage premium $W-\underline{w}$.

3.3 Loan sanctions in comparison

If a dictator needs to borrow to pay for palace building, loan sanctions also reduce the population's short-term consumption. For this case where $a<\mu(P_M+W)/(1-\mu)+\underline{w}$, μ workers lose the wage premium $W-\underline{w}$ when a loan sanction is imposed. If a dictator can pay for a palace without borrowing, the population does not suffer this short-term cost of lower wages. In either scenario, a loan sanction makes the population better off in future periods: when lending to dictators is cut off, the population is not saddled with that debt in the future. With no debt repayment to make, its period-2 utility increases by $u(A)-u(A-D/\beta)$. If this amount exceeds

[8] Another rationale for sanctions is that the threat of them improves the behavior of an existing government. This effect is captured by our model if the production of a new government at the beginning of the period is instead construed as a change in the behavior of an existing government. A further argument for sanctions is that they may hasten the fall of the government. We do not model this effect.

$\mu(u(W)-u(\underline{w}))/\beta$, which seems plausible, a loan embargo is welfare-improving for the population *ex post*, even setting aside its effect on the probability that dictators come to power. [9]

Loan sanctions have a second advantage. While third parties have incentives to break trade sanctions, banks have incentives to abide by a loan sanction, since any credit issued will not be repaid. If a single foreign country offers a safe haven to a country that has repudiated odious debt by changing its laws to prevent the country's assets from being seized by creditors, this would eliminate any incentive for the country to repay the debt. Or, if simply the reputational equilibrium changes to one in which a few creditors are willing to lend to a country that has renounced odious debt, profit-minded banks will not want to originate odious loans. Trade sanctions, in contrast, are eviscerated by a few defectors, even if there are many abiders.

3.4 Relaxing assumptions

A case worth considering is when instead of staying in power for one period, odious regimes lose power stochastically (or deterministically stay in power for many periods). Even in this case, loan sanctions retain their attractive features. Banks might issue short-term loans to the odious regime as long as they believed that the regime would be in power long enough to repay them. The risk that the regime will lose power before it can repay the short-term loan will increase the interest rate (such that, in expectation, the current regime repays the loan), so the regime is worse off with the loan sanction than without, and thus the prospect of loan sanctions may deter odious regimes. Moreover, regardless of when the regime loses power, the population has a smaller debt burden when the sanction is in place since it does not have to repay odious debt that is outstanding when the dictator is toppled.

[9] If a trade sanction prevents a dictator from depleting a non-renewable natural resource (that has no domestic market), then the trade sanction could confer a similar benefit on the population. They would inherit a larger stock of natural resources.

In the appendix, we relax the assumption that dictators only take power in the first period. It remains the case that loan sanctions against dictators limit the debt burden that dictators can bequeath to the country. In this generalized case, odious regimes may inherit debt from the previous government, and will always choose to default on it, regardless of whether loan sanctions are in place. Lending that adjusts for this risk can continue to take place.

4. Potential Biases

Although in our model the type of government is perfectly observable, in practice there is room for discretion in assessing whether loans to a particular regime are odious. Governments lie on a continuum in the extent to which they have the consent of the people and spend for their benefit, and some could argue that Mexican debt from the era of PRI domination or debts incurred in the U.S. before the passage of the Voting Rights Act of 1965 qualify as odious debt. One concern is that this latitude could be misused by whoever judges the odiousness of debt. We argue that a body empowered to declare only future loans illegitimate will have better incentives to prevent only and all odious lending than one empowered to rule on the legitimacy of existing loans. We also consider how biases in favor of or against particular governments would affect rulings.

Suppose there is a body that has the power to prevent seizure of assets to enforce repayment of certain loans. We assume the deciding body has a welfare function such that it receives utility $\alpha_G X$ from transferring X to the current government, $\alpha_B X$ from transferring X to banks, and $\alpha_P X$ when the population's consumption increases by X. α_G is a random variable that takes both positive and negative values while α_B and α_P are random variables that take only non-negative values. α_B and α_P are realized at the beginning of each period. α_G is realized immediately after the government type is realized. They are publicly observable by all players. We consider

two possible timings of the decision-maker's actions: (1) before banks make lending decisions and (2) at the end of the period in which the lending decision was made.

If α_P is sufficiently positive—e.g., the deciding body values the welfare of people in poor countries more than the interest of creditors—and rulings are issued *ex post*, existing non-odious debt will be declared illegitimate as a way to redistribute resources from creditors to the debtor country. This creates a time-consistency problem. Creditors will not lend, anticipating that even loans to non-odious governments will be branded illegitimate. In contrast, this bias does not pose the same problem *ex ante* since it creates an incentive to allow lending to occur when it benefits the population, that is, when the government is not odious.

If α_B is sufficiently positive, *ex post* announcements again create problems. A body with a bias in favor of banks might treat debt as legitimate, regardless of the odiousness of the regime that incurred it, so that banks will be repaid. In contrast, if the ruling is *ex ante*, either ruling produces zero profits for banks, leading other considerations to dominate any level of favoritism towards banks. Thus, the decision-maker will brand the regime as illegitimate from the beginning if the value it places on the country's population outweighs the value it places on the dictator's welfare.

Because α_G, biases toward governments, can be negative, either *ex ante* or *ex post* judgments could affect rulings. First, consider the case in which the body assesses loans *ex post*. If the borrowing regime was odious, but the decision maker dislikes the successor regime, it might announce that the regime was legitimate to hurt the successor. Conversely, if the borrowing regime was non-odious, but the deciding body favors the current regime, it might rule the debt illegitimate to free the country from its debts. With *ex ante* rulings, favoritism toward the current regime might induce a false negative; an odious regime would be allowed to borrow. A preference against a regime could lead to false positives, that is, rulings against non-odious regimes. In short,

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preferences for or against governments do not generically provide reasons to prefer either *ex ante* or *ex post* ruling. However, if we make assumptions about correlations between regime type and realizations of α_G, then preferences over governments may support a particular timing. Specifically, if one believes that odious regimes tend to be disliked and so negative α_G realizations are correlated with odious government realizations, then *ex ante* announcements are better.

If the policy goal is to do no worse than the status quo of indiscriminate lending, then safeguards against false positives could be put in place. With *ex ante* judgments, a false judgment in favor of a particular odious regime would move the outcome closer to the status quo. However, biased judgments against particular non-odious governments (e.g., for foreign policy reasons) could yield outcomes worse than the status quo, depriving countries of beneficial loans. One way to limit such outcomes is to require that a ruling of odiousness have the backing of a supermajority of the deciding body's members. With a supermajoritarian voting rule, if members' biases are not completely correlated, the decisive voter would be less biased against the government than under a simple majority rule.

5. Concluding Remarks

The debt relief movement rests on two main arguments: debt further impoverishes poor countries, and loans were often illegitimate in the first place. Economic models of debt overhang support the first argument, finding that debt relief may enhance efficiency if a country's debt is large relative to its GNP. In part in response, donors have granted debt relief to several debtor countries under the Heavily Indebted Poor Countries policy initiative. However, many other countries like post-apartheid South Africa are not eligible for HIPC debt relief, yet have a case that the debt they bear was illegitimate. Given the extent of looting and repression by many dictators, it seems plausible that the efficiency gains from preventing odious debt are similar to or larger than

the efficiency gains from solving debt overhang.

This paper has argued that rulings about which regimes are odious could potentially deter lending to odious governments. Equilibria with lending to governments deemed odious could be eliminated by changing laws to offer a successor government that repudiates odious debt a safe haven for its assets, where the assets could not be seized by creditors who had lent to the odious regime. By empowering the decision-making body to rule only on the legitimacy of future loans, favoritism toward debtor countries could be kept in check.

Loan sanctions are self-enforcing, unlike trade sanctions. Even when trade sanctions work, they can hurt the population; loan sanctions are less likely to suffer this problem. Since more countries engage in foreign trade than in sovereign borrowing, a loan sanction could only be applied in certain cases, but in these cases, such as apartheid South Africa as discussed earlier, it could have a significant impact.

It is also worth noting that creditors would potentially be better off under a system in which the "rules of the game" are known in advance. Currently, there is a movement to nullify some debt on the grounds of odiousness, but it is hard for creditors to anticipate which loans will be considered odious in the future. If odiousness were declared in advance, banks would avoid lending in the first place and suffer some foregone benefits, but they would not risk large losses from a successful *ex post* campaign that nullified some of their outstanding loans. Accordingly, interest rates could fall for legitimate governments.

Loan sanctions, rather than being adopted as policy in the abstract, may be more likely to be imposed in a specific case and then evolve into a general policy. For example, the U.S. recently pressured the ratings agency Moody's to withdraw its favorable credit rating of Iran. Iran planned to issue sovereign bonds, and the U.S. wanted to limit Iran's ability to borrow as part of its

economic sanctions program.[10] However, eliminating the Moody's rating is unlikely to compel bond purchasers to fall in line with the U.S. position. Suppose, though, that the U.S. declared that if a successor government in Iran repudiated the bonds in the future, it would allow the successor to place assets in the U.S. and would protect them from being seized. Anticipating the future Iranian government's incentives to default, would-be bondholders would very likely fall in line with this sanction.

This hypothetical example brings out a potential danger of a more effective form of economic sanction: countries would have greater scope to act unilaterally. Much of the world might prefer a system that required international consensus in order to impose loan sanctions. For example, the UN Security Council could decide on loan sanctions, a natural extension of its role in imposing trade sanctions. The United States and other major powers would have veto rights, and while their ability to act unilaterally would be constrained, they would gain veto power over other countries' actions. In the long term, an international court as the deciding body is another possibility.

[10]"Moody's, Citing U.S. Concern, Cancels Ratings on Iran Debt" (*New York Times*, June 4, 2002).

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Appendix

To be written