Principles for Prevention of Sovereign Debt Crises: A Historical Opportunity
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At the recently concluded UNCTAD XIII Conference in Doha, Qatar, a High-Level Roundtable on Debt Prevention and Management was held to discuss new Principles on Responsible Lending and Borrowing, which have been under discussion since 2009. The Principles are forward-looking and symmetrically cover issues on the lender and borrower sides; and they are comprehensive, in contrast to other existing ad hoc single-issue-focused initiatives; they take a soft-law approach with a view to build consensus. Most importantly, these Principles emphasize full information disclosure by lenders and borrowers as a means of enforcing accountability and discipline in lending and borrowing.

The discussion of these Principles is quite opportune historically. Indeed, we are about three months away from the 30th anniversary (so to speak) of the outbreak of the Third World Debt Crisis, when in August 1982 Mexico defaulted on its external sovereign debt. This ushered in a long period of debt distress that sent economies in a tailspin, with declining incomes and rising poverty over the subsequent two “lost decades”, as the ’80s and ’90s came to be known later.

When the Third World Debt Crisis occurred 30 years ago, the first mistake made by the global community was to identify the crisis as a problem of developing countries only, rather than a symptom of systemic deficiencies of the international financial system. As a result, ill-devised solutions were applied to an ill-diagnosed problem. The austerity policies imposed on developing countries stunted growth for decades, plunging populations into deep poverty.

Secondly, the guilt for the debt crisis was asymmetrically assigned to the debtors while exonerating the lenders. Consequently, restrictions on spending and borrowing were imposed on debtor countries while creditors were bailed out indirectly by giving developing countries “life support” in the form of new loans enabling them to repay past loans.

The recent financial crisis has demonstrated two things: that debt crises are not a thing of the past; and that debt crises are not a problem of developing countries only.

Unfortunately, once again, the costs of the debt crisis have disproportionately fallen on the debtors, as the financial tsunami swept away households’ life savings including homes, while their creditors were bailed out and got away with reckless lending practices. It is high time for the global community to wake up to the fundamentally systemic nature of
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sovereign debt crises and devise comprehensive strategies that pave the way for a more stable global financial system. In this context, the proposed UNCTAD Principles are quite welcome and opportune.

Developing countries are at a critical crossroads today. They have regained strength and emerged as the next growth poles, especially as industrialized countries struggle to overcome the great recession of this century. South-South trade and investment flows are at record highs. Some low-income countries in Africa are gaining middle-income status thanks to improved economic performance. The emerging economic dynamism in the South is likely to attract higher financial inflows, including sovereign debts, as capital in the North chases higher returns in the South.

As low-income countries begin to breathe fresh air following debt relief, it is critically important to minimize the risk of a new cycle of debt buildup. But more generally it is important to design mechanisms to prevent unsustainable debt and ensure that resource inflows are invested in productive activities to build adequate repayment capacity. In other words developing countries should take more debt only when it buys more growth.

As the UNCTAD Principles are discussed and negotiated, it is important that the global community does not miss the opportunity to deal with the case of past debts that still constitute a serious burden on many developing countries. While debt service obligations have substantially declined following debt relief, many developing countries remain vulnerable and are still paying a large share of their scarce foreign exchange revenue to service past debts.

The past debts shouldered by the current generations in developing countries include virtuous debts that contributed to economic development, but also imprudent loans that financed ‘white elephants’, as well as ‘odious debts’ which financed empires of corrupt leaders and their private acolytes. Evidently, developing countries benefited substantially from loans that were efficiently managed and financed transport and energy infrastructure, health and education programs, trade-enhancing initiatives, and other development programs. It is this kind of loans that the UNCTAD Principles seek to encourage in the future.

The Principles should be extended to cover the third type of past debts – ‘odious debts’. This is not a trivial issue for several reasons. First, these loans constitute a substantial fraction of past debts. The evidence presented in Africa’s Odious Debts: How Foreign Loans and Capital Flight Bled a Continent suggests that out of each dollar borrowed by Sub-Saharan African countries over the past four decades, more than half was siphoned out as capital flight and ended up financing private wealth accumulation in safe havens.

Second, this situation is morally reprehensible as it forces current and future generations in developing countries to make painful sacrifices to service debts that did not serve their interests.

Third, overlooking the case of odious loans exonerates creditors of corrupt regimes who did not exercise due diligence in lending. This would perpetuate moral hazard problems in the global financial system where corruption on the borrower side and the complicit ‘helping hand’ on the lender side conspire to mortgage the future of generations in developing countries.
To help shed light on past odious debts, indebted countries would undertake audits of national debts to establish the legitimacy of past and outstanding debts. Debts that are found to be odious would be repudiated. Such debt audits must be done transparently, objectively, and competently by independent experts to form the basis for selective debt repudiation. Recently, Ecuador successfully completed an audit of its past debts, some of which were found ‘odious’ and subsequently repudiated. To further ensure objectivity of the selective debt repudiation process, an international debt arbitration institution could oversee the determination of the legitimacy of debts, past and future. In 2005, the Norwegian Government proposed the establishment of an International Debt Settlement Court just for this purpose.

The preparation of the proposed Principles also offers an opportunity to consider other forms of financial instruments that predispose countries and the global financial system to frequent and damaging debt crises. This includes products such as derivatives and other complex instruments that tend to evade the scrutiny of the regulator. The practice of shifting financial risk onto unsuspecting borrowers needs to be discouraged through clear principles.

The proposed Principles have deliberately taken a soft-law approach (consensual, technically non-binding), which has the advantage of flexibility and is better tailored to build consensus and buy-in. But looking forward the question is whether there is scope for a move toward more formalization of binding principles. The global community has the opportunity to make sure that our global financial system does not carry forward the legacies of greed, gaming, and financial engineering that have undermined financial stability and development financing. Compromises will certainly have to be made for this goal to be achieved; but that is the price to pay for global financial stability and sustainable development.