Third World Quarterly, Vol. 27, No. 2, pp 211–226, 2006

Routledge
Taylor & Francis Group

ARTICLES

'Illegitimate' Loans: lenders, not borrowers, are responsible

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ABSTRACT *Debt relief has focused on the borrower—debt is cancelled if a country is too poor to repay and now has acceptable policies. Iraq shifted the focus to the lender—debt should be cancelled because creditors should never have lent money to the repressive regime. This paper uses domestic and international law to establish the concept of 'illegitimate debt', which should not be repaid independent of the status of the borrower. The concept of 'moral hazard' is used to argue that non-payment of illegitimate debt is necessary to discipline lenders and to prevent future lending to oppressive dictators.*

'Certainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who is now gone', said the US Treasury Secretary John Snow.[1] The US-led campaign for the cancellation of Iraqi debt emphasised that money should not have been lent to the dictatorial regime of Saddam Hussein, and that the lenders should be liable for those improper loans, not the people of Iraq who had no say in the borrowing. It is a view which the USA also took 105 years earlier, when it occupied Cuba and refused to pay Cuba's debts because they had been 'imposed upon the people of Cuba without their consent and by force of arms'.[2] In particular, the USA declared that the creditors must have known that their loans were for 'the continuous effort to put down a people struggling for freedom from the Spanish rule' and therefore accepted that the loan was obviously risky.[3]

Focusing on lenders is a total reversal of recent international policy, which has put the emphasis on the borrower. When a country cannot pay its debts, if is often given some form of 'debt relief', usually involving conditions and methods of enforcing discipline in the hope that the wayward borrower does not get into trouble again. The Heavily Indebted Poor Countries (HIPC) Initiative of the World Bank and International Monetary Fund (IMF) has criteria totally based on the borrower, which must be poor and have acceptable policies. The eligibility for, and amount of, debt reduction is totally determined by the creditors. In order to be eligible for HIPC, 'a country should have a track record of macroeconomic stability, have prepared an Interim Poverty Reduction Strategy Paper, and cleared any outstanding

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ISSN 0143-6597 print/ISSN 1360-2241 online/06/020211–16 © 2006 *Third World Quarterly*
DOI: 10.1080/01436590500432283

arrears'. Then 'staffs of the World Bank and IMF', the main creditors, determine 'the amount of debt relief it may receive'.[4]

A substantial body of recent research shows that HIPC debt relief is ineffective.[5] In an earlier article we looked at the amount of debt relief which is necessary to meet the Millennium Development Goals.[6] In this article we look at the other end of the lending relationship—at the lender. Instead of 'can't pay', we look for cases of 'shouldn't pay'.

The US argument about Iraqi (and before that, Cuban) debt also adopts this view, saying that debt cancellation is dependent on prior actions of the lender, not on the present conditions and actions of the borrower. It is an issue which has been raised in the South, where campaigners have argued that the international financial institutions (IFIs), notably the World Bank and IMF, have been particularly notorious for lending to dictators. Mike Moore, the former secretary general of the World Trade Organization, argues simply that 'Debt hangs around poor countries' necks like a noose. Much of this money was lent during the Cold War to prop up gangsters and criminals'.[7]

Lending to dictators continues, with the World Bank giving loans, for example, to the government Uzbekistan, which has an appalling human rights record and where the United Nations found that torture is 'systematic'.[8] Yet the World Bank *Uzbekistan Country Brief* said nothing about human rights and only complains about 'an unfriendly business environment'; its four 'challenges ahead' for the country are all about macroeconomic stability, removing barriers to trade, and privatisation.[9]

Moral hazard

If the lesson of Iraq is that the IFIs and other lenders should not have lent to Saddam Hussein, why have they have not learned their lesson? The IMF (which is not lending to Uzbekistan) pointed to the problem in 1998:

> Moral hazard exists when the provision of insurance against a risk encourages behaviour that makes the risk more likely to occur. In the case of IMF lending, the concern about moral hazard stems from perceptions that the availability of financial assistance may weaken policy discipline, encourage international investors to take on greater risks in the belief that they will only partially suffer the consequences, or both.[10]

In other words, if lenders, including the IMF itself, can lend to the most corrupt and brutal dictator and be sure of getting their money back, that is moral hazard.

For the first time since the IMF's founding, a US Treasury Secretary seriously suggested that it should not get its money back. Snow put very firmly on the table the view that international lenders should be held liable for their own improper lending, and this presages the end of the comfortable system whereby the IFIs enforce repayment no matter how outrageous or foolish the loan. In this paper we argue for international lender liability in a new era. We will define a concept of 'illegitimate debt' and we will look at the

issue of lender liability not only through international law, but also in terms of national law, noting that much dubious international lending would not have been acceptable within most countries under their domestic law.

The intention here is to enforce discipline in the hope that the wayward lender does not make the same mistake again. Moral hazard and lending to repressive regimes can only be prevented if lenders are penalised for past illegitimate loans. Concern about moral hazard applies to the lender, not the borrower.

The growing doctrine of lender responsibility

International law says surprisingly little about bad loans and, under normal circumstances, a loan to a country becomes a debt of the state; successor governments inherit the liability and are expected to repay the debt.[11] But there is also a long history of refusal to pay debts on political grounds. Following the US civil war, in which the southern states declared independence and were then defeated, the 14th amendment to the US constitution was passed in 1868, which declares 'neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave; but all such debts, obligations and claims shall be held illegal and void'. In 1900, when Britain annexed the Boer Republic in what is now South Africa, it refused to repay loans it said the Boer Republic had taken for war purposes. And the Treaty of Versailles in 1919 exempted from repayment debts of Poland which were said to be incurred for the purposes of Prussian and German colonisation of Poland. The most widely cited example occurred when the USA seized Cuba and the Philippines from Spain in 1898. Spain demanded that the USA pay Cuba's debt, but the USA refused, on the grounds that the debt had been 'imposed upon the people of Cuba without their consent and by force of arms'. Furthermore, the USA argued that, in such circumstances, 'the creditors, from the beginning, took the chances of the investment'.[12]

The next step in codifying lender responsibility in international law was a landmark arbitration ruling in 1923 by US Supreme Court Chief Justice Taft. A Costa Rican dictator, Frederico Tinoco, was overthrown and the new government refused to repay loans made by the Royal Bank of Canada to the Tinoco government. Taft ruled that the payments were made by the bank to Tinoco himself and that the case of the Royal Bank depended

> upon the good faith of the bank in the payment of money for the real use of the Costa Rican government under the Tinoco regime. It must make out its case of actual furnishing of money to the government for its legitimate use. It has not done so. The bank knew that this money was to be used by the retiring president, F Tinoco, for his personal support ... The Royal Bank of Canada cannot be deemed to have proved that the payments were made for legitimate governmental use. Its claim must fail.[13]

The next step was a study by Alexander Sack, an expert on the obligations of successor governments, who formalised this into the doctrine of Odious Debt. He wrote:

> If a despotic power incurs a debt not for the needs or in the interest of the state, but to strengthen its despotic regime, to repress the population that fights against it, etc, this debt is odious to the population of all the state. This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, consequently it falls with the fall of this power . . . The creditors have committed a hostile act with regards to the people; they can't therefore expect that a nation freed from a despotic power assume the 'odious' debts which are the personal debts of that power.[14]

The concept of Odious Debt was further recognised by the British House of Commons International Development Committee, which declared that:

> the bulk of Rwanda's external debt was incurred by the genocidal regime which preceded the current administration . . . Some argue that loans were used by the genocidal regime to purchase weapons and that the current administration and, ultimately, the people of Rwanda, should not have to repay these 'odious' debts . . . We further recommend that the [UK] government urge all bilateral creditors, in particular France, to cancel the debt incurred by the previous regime.[15]

Lender responsibility runs through all these rulings. The main points are:

1. Certain debts are odious or illegitimate and fall with the regime and are not owed by successors.
2. Loans taken to strengthen a despotic or oppressive regime are odious.
3. A lender must act in good faith, and cannot collect on a loan it knew, or should have known, was being misused.
4. Debts can be considered odious if they are used for personal rather than state purposes.
5. The burden of proof is not on the successor state to prove odiousness, but for the lender to prove legitimacy.

Furthermore, Sack argues that creditors commit a hostile act when they make an odious loan, suggesting that not only does the successor government not have to repay the loan, but it can also make a claim against the lender.

Domestic law

Law around domestic lending developed much more rapidly in the 20th century, and has significantly increased the responsibility of the lender to act in good faith. Courts are unlikely to enforce the repayment of loans which involve fraud or which are funding illegal activities. Borrowers are unable to bind their children to repay debts. Good faith and prudence require lenders

to make at least a cursory assessment of the borrower's ability to repay. Lenders cannot cheat borrowers.

In this context the UK's Consumer Credit Act 1974 (Section 138) sets an important benchmark which we will try to apply more broadly. That law emphasises lender responsibility and liability. It says that 'a credit bargain is extortionate if it (a) requires the debtor ... to make payments ... which are grossly exorbitant, or (b) otherwise grossly contravenes ordinary principles of fair dealing'. This definition is extremely broad, and the courts have wide powers to cancel the debts or change the terms. The court is expected to take into account the borrower's 'age, experience, business capacity and state of health', the degree to which the borrower was under 'financial pressure and the nature of that pressure', and 'any other relevant consideration'. British courts have, for example, ruled that a loan could be considered 'extortionate' when the borrower had no choice in their financial circumstances but to accept the terms of the loan,[16] and have also found that failing to assess the credit-worthiness of the potential debtor contravenes ordinary principles of fair dealing.[17]

Finally, the Consumer Credit Act 1974 reverses the normal burden of proof: if a debtor alleges that a credit bargain is extortionate, the burden of proof lies on the creditor to prove that the bargain is *not* extortionate.[18]

The minimum case: knowingly making bad loans to dictators

Surely there can be no question that banks and international financial institutions must accept responsibility and cannot collect on loans which were knowingly made to corrupt and nasty dictators. We cite just four examples.

In 1965 General Joseph Mobutu took power in the Congo (which he renamed Zaire). Mobutu became one of the world's most corrupt dictators. In 1978 the IMF appointed its own man, Irwin Blumenthal, to a key post in the central bank of Zaire. He resigned in less than a year, writing a memo which said that corruption was so serious that there was 'no (repeat no) prospect for Zaire's creditors to get their money back'.[19] Shortly afterwards, the IMF granted Zaire the largest loan it had ever given an African country; over the next decade it gave Mobuto $700 million. Zaire had virtually stopped repaying its debts in 1982, but in the next decade the World Bank lent $2 billion to Zaire. Western governments were the biggest lenders, and continued to pour in new money. When Blumenthal wrote his report, Zaire's debt was $4.6 billion. When Mobuto was overthrown and died in 1998, the debt was $12.9 billion.[20] There is perhaps no clearer example of odious debt.

The Philippine dictator Ferdinand Marcos was overthrown in 1986 and fled into exile with between $5 billion and $13 billion in foreign banks;[21] he had stolen one-third of the Philippines' foreign loans. The largest single debt of the Philippines is for the Bataan nuclear power station. Completed in 1984 at a cost of $2.3 billion, it was never used because it was built on an earthquake fault at the foot of a volcano. 'Filipinos have not benefited from a single watt of electricity', said the national treasurer, Leonor Briones, but the Philippines still pays $170 000 per day for the power station and the debt will

not be repaid until 2018. Marcos received bribes of at least $80 million and much of the construction was done by companies in which Marcos had an interest.[22] It would be hard for any bank to say it was acting in good faith by lending to build a nuclear power station on an earthquake fault. At least some of these loans must be odious.

In 1973 the UN began to describe apartheid in South Africa as a crime against humanity and in 1977 it imposed a mandatory arms embargo on South Africa. But lending continued and debt had reached $24.3 billion by the end of 1984.[23]

A military junta was in power in Argentina from 24 March 1976 to 1983. In those seven years the junta and its allies in right-wing militias killed at least 30 000 people,[24] while foreign debt rose from $8 billion to $46 billion, most of it owed to banks. Soon after the military took power, it began clandestine borrowing, particularly from US and British banks, in ways which violated Argentinean law. Researcher Alejandro Olmos found that British banks 'knew that the money never went to Argentina but remained in accounts in London'.[25] Olmos filed a criminal accusation and in 2000 Federal Judge Dr Jorge Ballesteros ruled that the debt contracted during the 1976–83 dictatorship was illegal and illegitimate. Ballesteros noted that:

> the exact co-responsibility and eventual guilt of the international financial institutions (particularly the IMF and the World Bank) must be established, as well as that of the creditors, because during the whole period under examination (1976 to 1982) many technical missions sent by the IMF visited our country ... The conclusion is that the creditor banks, the IMF and the World Bank acted with imprudence themselves.[26]

Thus the Federal Judge established many of the conditions for the illegitimacy of this debt. He has ruled that it was taken by the regime, not the country, and he has ruled that the IMF and World Bank acted imprudently. Olmos' discovery that money stayed in London also creates the same conditions as in the Tinoco arbitration ruling.

Loans for a nuclear power station on an earthquake fault bought by a corrupt dictator, loans to a state which is officially committing a crime against humanity, loans to an oppressive dictator who they knew would never repay, and loans to a dictatorship with the money staying in London satisfy all the conditions for odious debts knowingly made. At this point, we argue that there is a *prima facie* case that, at the very minimum, some of these debts are odious and are the liability and responsibility of the lenders. This is the critical assertion. The IFIs and other lenders have fought very hard against this, because until now they have not had to take any responsibility for incompetent and corrupt lending. International lenders realise that, once a concept such as the British one of 'extortionate debt' is accepted for international debt, a significant portion of their past, present and future lending comes under scrutiny. Decades of unconstrained lending, in which repayment would be enforced no matter how unwise or odious the loan,

means that substantial parts of loan portfolios could be questioned. No wonder international lenders continue to dismiss the idea that they should take some responsibility for their loans, and continue to lend to dictators and countries where torture is systematic.

More than a quarter of developing country debt, over $735 billion, can be attributed to dictators in 23 different countries (see Table 1).

Most of these dictators were backed by the USA and the West, although Mengistu Haile Mariam was backed by the USSR and Siad Barre gained support from both East and West at different times. In the terms set out by Alexander Sack these are all, arguably, odious debts which are personal debts of those dictators and their regimes and which, in Sack's words, 'fall with the fall of this power'. A paper for the IMF points to an analogous principle in corporate law, which is that a corporation is not liable for contracts entered

TABLE 1. Debts which can be attributed to dictators (US$ billion)

Indonesia	Suharto	150
Iraq	Saddam Hussein	122
Brazil	military	100
Argentina	military	65
Philippines	Marcos	40
South Korea	military	30
Nigeria	Buhari/Abacha	30
Syria	Assad	22
South Africa	apartheid	22
Thailand	military	21
Morocco	Hassan II	19
Pakistan	military	19
Sudan	Nimeiry/al-Mahdi	17
Chile	Pinochet	13
Zaire/Congo	Mobutu	13
Peru	Fujimori	9
Ethiopia	Mengistu	8
Algeria	military	5
Iran	Shah Reza Pahlavi	5
Kenya	Moi	5
Mali	Tragore	3
Bolivia	military	3
Somalia	Siad Barre	2
Paraguay	Stroessner	2
Malawi	Banda	2
Nicaragua	Somoza	2
Rwanda	Habyarimana	1
El Salvador	military	1
Liberia	Doe	1
Haiti	Duvalier	1
Uganda	Amin	1
Togo	Eyadema	1

Sources: Updated from J Hanlon, *Dictators and Debt*, London: Jubilee 2000, 1998, available at http://www.jubileeplus.org/analysis/reports/dictatorsreport.htm; and D Millet & E Toussaint, 'Ideas for alternatives', Brussels: Comité pour l'Annulation de la Dette du Tiers Monde (CADTM), 2003.

into by its senior officers without proper authority.[27] This is similar to a dictator taking loans without proper consent of the people or their representatives.

There is a clear case of moral hazard here. When Nelson Mandela walked out of prison in South Africa in 1990, the international banks handed him a bill for $21 billion—effectively demanding that he pay the cost of keeping himself in jail. If the banks can demand that a prisoner and victim pay the cost of a crime against humanity, then it means there are no limits on lending. If we genuinely expect to prevent loans to Saddam Hussein in Iraq and Islam Karimov in Uzbekistan, then the only possible way of preventing moral hazard and halting such loans is by penalising the lenders. This has nothing to do with the goodness of the people and governments of the Congo, South Africa or the Philippines; it is entirely about penalising the lenders for loans which supported massive violations of human rights. Equally, it is about drawing a line and saying that such loans would never have been acceptable under national law, and that internationally the same duties of care to the borrower—fair dealing and acting in good faith—must be applied.

From odious to illegitimate

Towards the end of the 1990s, with the growth of the Jubilee 2000 movement to cancel the 'unpayable debt of the poorest countries' by 2000, there were demands from activists and civil society in the South to cancel or repudiate what they called 'illegitimate debt'. This was intended to be more than an odious or dictators' debt, and was seen as a broader category of debts which were the liability of the lender and not the borrower. Indeed, the loans already cited for a nuclear power station on a fault line or knowingly made for capital flight are not just improper because they were made to a dictator, but because they contravene ordinary principles of fair dealing and thus would have been unacceptable in domestic law.

The broader concept of 'illegitimate debt' is quite new and there have been various attempts to define what should be included. Jubilee 2000 eventually declared that 'all illegitimate debt, in accordance with the Doctrine of Odious Debt, and debts resulting from failed development projects should be cancelled'. Jubilee South argued 'that the purported debt of the South to the North is illegitimate'. It cited loans given to support apartheid and other dictatorships, loans that fuelled corruption, and loans for dams and mining projects that caused 'environmental and social damage'. High interest rates mean many new loans are only used to repay old loans, increasing indebtedness. Jubilee South argued that the World Bank and IMF use indebtedness to impose conditions 'designed in the interest of the elites in the North' and 'further impoverish the poor'. Other campaign groups argue that debt is also illegitimate where it has funded capital flight, where it has been linked to bad policy advice and bad projects, and where private loans have been converted to public debt under duress in order to bail out lenders.[28]

Southern campaigners argue that loans for failed projects are illegitimate, and this has gained backing from the UN Institute for Training and Research. It argues:

> Developing countries rely on external expertise because they lack the technical know-how and assistance to plan infrastructure policies and to implement projects. Consequently, developing countries should not bear the burden of . . . bad planning and bad implementation performed by external sources . . . [C]omparative law studies indicate that modern civil and commercial law has broadened contractual obligations in complex business transactions beyond the strict delivery of goods . . . to include dissemination of professional information, exchange of motivated opinions, discovery of special risks, and instructions and consultations, especially if one party is less knowledgeable than the other and therefore must trust the other's superior skills. Neglecting these accessory obligations may be considered a breach of contract . . . and should be all the more applicable if the lender is an official donor with the statutory obligation to finance and assist in the execution of development projects.[29]

In particular, this should apply to the World Bank, which plays a central role in planning the projects for which it makes loans. Dam projects all over the world, many funded by the World Bank, have been unsuccessful. The Tanzania Coalition on Debt and Development says Tanzania owes the World Bank more than $575 million for 26 failed agricultural projects. In Nigeria, at least 61 development projects financed by more than $5 billion in foreign loans have either failed or never opened, according to a government commission.[30]

Usury—lending at excessive interest rates—is widely considered to be illegal and improper for domestic lending and in many countries courts have the right to cancel or reduce loans when the interest rates are excessive. But there is no simple rule as to what actually constitutes usury. In the mid-1970s, international loans had a *negative* real interest rate—that is, interest rates were lower than inflation, which meant borrowers actually had to repay less than they borrowed. The borrowers thought the loans were cheap and became trapped, because the interest rates were variable and real rates were pushed up to 12% in the early 1980s.[31] At the same time, banks stopped lending; from 1983 Latin America was paying more in debt service than it received in new loans, and this continued into the new century. For Latin America virtually all post-1982 debt is really a result of the interest rate rise. Argentina is one of the more extreme cases. All its debt was at variable interest rates, and its interest payments jumped from $1.3 billion in 1980 to $4.4 billion in 1985. That was a jump from 12% of export earnings to 43% of export earnings. Is 43% of income a usurious interest rate? In the terms of the British Consumer Credit Act, it surely constitutes payments 'which are grossly exorbitant'.

Another way to look at the usury question is to ask how countries are repaying the debt. Most loans are in the currencies of industrialised countries, and under IMF and World Bank structural adjustment policies,

countries were forced to devalue substantially. For Mozambique devaluation was so rapid that between 1986 and 1990 the interest rate in local currency on so-called 'concessional' loans was 123%. Most poor countries are raw material exporters and the other way to look at repayments is to ask how many tonnes of cotton or coffee or sugar are required to repay the debt. In the 1980s coffee prices fell by nearly 11% a year, so Rwanda, which had 'concessional' loans at 1.5% interest, was still exporting coffee to pay the loans and the 'coffee interest rate' on the loans was 12%.

'Illegitimate' and 'illegitimate debt' have no clear meanings in law and have not been commonly used until recently. Chief Justice Taft seems to have been the first to use the term 'legitimate' with respect to debt. The term 'legitimate debt' seems not to have been used in any law or court ruling until the Argentine ruling in 2000. Apparently the first time the term 'illegitimate debt' was used by the IFIs was in a paper to an IMF conference in March 2002.[32] But it is clearly intended that 'illegitimate debt' should be broader than simply 'odious debt'. We propose as a starting point not to try to make a precise definition, but rather to take a functional definition:

> Illegitimate debt consists of loans which were improperly granted and are thus the liability of the lender and are not to be repaid.

Elsewhere, we have looked in much more detail at how we might define illegitimate debt more precisely,[33] but this simpler definition is sufficient here because our purpose is to look at international lending through the lenses of national law and odious debt, and show that at least some loans to dictators are odious, some loans for failed projects are illegitimate, and some effective interest rates are usurious. Thus the initial minimum case is that at least some international loans are illegitimate and should not be repaid.

Loan laundering and fungibility

In the previous section we showed that at least some loans are, indeed, illegitimate, and the borrowing country should not be expected to repay. However, attempts to identify which loans are illegitimate are complicated by two fiscal issues—rolling over of loans, and claims that even loans to notorious dictators can be acceptable.

After the loan crisis of 1982 many countries were unable to make principal repayments and often could not even pay the new higher interest charges. Thus during the 1980s and 1990s these loans were repeatedly rolled over—new loans were made to repay the old ones. A more recent example is the case of the Democratic Republic of the Congo (DRC, formerly Zaire). It was in arrears to the IMF because it was not repaying the debt of the old Mobutu regime, but this had the effect of blocking other aid since donors will not help a country which has no IMF programme. Four countries—France, Belgium, South Africa and Sweden—in 2002 gave the DRC a bridging loan of $522 million to pay the IMF. The IMF immediately gave the DRC a new loan of $543 million, of which $522 million went directly back to the four countries

to repay the bridging loan.[34] No matter what the status of the original loan, this is a new loan agreement with the IMF by a new government, while Mobutu's possibly odious loan had been repaid.

Here we argue by analogy with money laundering, where drug profits and other illegal gains are passed through a series of bank transactions in an effort to wash away the original illegal taint. Governments have argued that it is possible to pursue the original money through the chain and label at least some of the laundered funds illegal; in some cases such funds have been reclaimed or confiscated. In a similar way, we argue that a process of 'loan laundering' is taking place. Loans are rolled over or replaced by new loans in ways that attempt to wash away the original taint of odiousness. But the IMF itself makes clear that its new loan to the DRC is just a laundered version of the old one. By rolling over the Mobutu loan in this way, through the trick of a bridging loan by other countries, the IMF cannot be allowed to wash its hands of the original odious loan.

A similar problem arises with the argument by lenders that they knew that the country was run by a corrupt and evil dictator, so they were careful to ensure that their loans were only for projects that benefited the people. There are two responses to this. The first was made by the USA in 1898 when it said that Cuban debt was illegitimate because it had been 'imposed upon the people of Cuba without their consent and by force of arms'. This does not allow space for good projects, and clearly states that all dictators' debts are illegitimate. The second response is more subtle and contemporary and looks at the fungibility of foreign currency.[35] 'What is to prevent the government from funding roads and ports with foreign loans while using taxpayer funds to buy tanks and submarines?' asked the IMF in a recent paper.[36] Aid or a loan can be supplied for a specific beneficial purpose but that releases the funds which the government would have used for the rural credit or the electricity line, and those funds can be used to buy arms or be put in a foreign bank account. Indeed, both were done in Argentina. When the apartheid state in South Africa became desperately short of foreign exchange because of sanctions in the 1980s, it perfected the technique of floating bond issues for seemingly acceptable projects such as expansions of the electricity grid. Many of these projects did not need foreign currency and could have been built using local currency, but the bond issues meant that South Africa obtained scare dollars despite sanctions.[37] Therefore, because of fungibility, all loans to odious regimes and dictators should be classed as odious, even if the ostensible purpose was permissible.

Declaration of illegitimacy

The final issue is how one might adjudicate claims and declare debt illegitimate. The UN Conference on Trade and Development emphasised that the IMF 'is not a neutral body and cannot, therefore, be expected to act as independent arbiter', because the IMF and its shareholders are themselves creditors. The most common proposal is for some sort of international

arbitration system, international court or neutral panel—for example internationalising the insolvency procedures for US municipalities, but using a 'neutral court of arbitration'.[38]

There is concern by some writers that *post hoc* decisions in illegitimacy will destabilise banking systems. The general response is that, in domestic lending, decisions by courts on legitimacy are *post hoc*, and banks have no difficulty with this, incorporating checks on legitimacy into the due diligence applied to all loans.

Naturally, lenders would prefer a prior declaration of illegitimacy, but this proves difficult to do. One suggestion is that the UN Security Council should declare a regime 'illegitimate',[39] but that would not work because illegitimate regimes such as that of Saddam Hussein or Mobuto normally have the backing of at least one major power which is a member of the UN Security Council, and which would use its veto to prevent having its client regime declared illegitimate.[40]

We suggest, instead, a prior declaration of legitimacy. Most international loans, particularly with the IFIs, are contracted by governments in secret. The Constitution of Uganda (article 159(2)) is unusual in that it specifies that 'Government shall not borrow, guarantee, or raise a loan on behalf of itself or any other public institution, authority or person except as authorised by or under an Act of Parliament'. It is proposed here that a loan will be considered automatically legitimate if 1) it is approved by a parliament; and 2) that parliament has been elected in an internationally recognised election.

Increasingly elections throughout the world are monitored by the European Union, the Organisation for Security and Co-operation in Europe (OSCE), the Commonwealth, the Carter Center in the USA, and other bodies. Although they no longer use the terminology 'free and fair', they do declare if an election has met international standards and it the results represent the will of the people.

Conclusion

The purpose of this paper has been to argue that, on the basis of the current Iraq debate, international law and domestic law, at least some international debt is illegitimate, and is the liability of the lender and not the borrower. James Wolfenson, president of the World Bank, commented that 'In the light of the debt relief initiative for Iraq, a lot of countries are saying "we also had debts assumed by people that shouldn't have assumed them". They are saying that if debt relief is happening for Iraq it should be happening for us too'.[41]

The purpose of this article is to say they are right. And 2005 saw increasing pressure in this direction. After the tsunami on 26 December 2004 killed tens of thousands of people in Indonesia, the Paris Club of bilateral creditors offered only a delay in debt service payments. In response, the International NGO Forum on Indonesian Development, based in Jakarta, called for a comprehensive solution to the debt problem, including a writing off of 'all debt that has to be considered illegitimate or odious in nature'.[42] As Table 1

shows, Indonesia has the highest level of dictator's debt in the world. On 19 April 2005 the Philippine Supreme Court Associate Justice, Reynato Puno, urged the government to stop paying for loans for the Bataan nuclear power plant. He said the debts were 'illegitimate and therefore should not be paid' because the lenders 'knew or had no reason not to know that the loans will be used for illegitimate purposes'.[43] In March 2005 the British government's Commission for Africa issued its report, which notes:

> There is strong resentment in many parts of Africa over these debt obligations, in part because much of the debt was incurred by unelected leaders supported by the very countries now receiving money to cover the service of those debts—and who, many Africans feel, are now using debt as a lever to dictate policy to the continent. There is a widespread feeling that the debts are unreasonable and that what was owed has in practice already been paid many times over.[44]

The Paris Club of bilateral creditors cancelled $30 billion of Iraqi debt on 21 November 2004 and $18 billion of Nigerian debt on 29 June 2005. Both countries are oil producers and neither qualifies for debt cancellation under present international systems. But both had campaigned for debt cancellation on the grounds that the debt was illegitimate and had been lent to dictators, and this clearly was a factor in the cancellation.[45]

Although there is now an implicit acceptance that some debt is illegitimate and should not be repaid, the decision on cancelling the debt still remains in the gift of the very agencies which made the improper loans in the first place. Until now the discussion of debt has put the emphasis on 'relief'—some debt is written off because countries are too poor to pay. The main international debt relief mechanism is the HIPC programme, which is conditional on poor countries jumping through a number of hoops relating to macroeconomic stability and openness of the economy, having a World Bank approved Poverty Reduction Strategy Paper, etc. It is basically a charitable exercise in which the debt of the 'deserving poor' is reduced but not totally cancelled. *Ad hoc* decisions on Iraq and Nigeria, which do not qualify for HIPC, have been taken in the same spirit.

Thus, the core of present debt relief thinking places consideration entirely on the borrower, and debt relief is seen as a carrot to force the debtor to adopt 'better' policies. The concept of illegitimate debt places consideration entirely on the lender, and debt cancellation is seen as a stick with which to force the lender to adopt better policies. If a loan was made improperly or illegitimately, then the lender should not be repaid, independently of the moral character and conduct of the borrower. The issue here is one of moral hazard—unless lenders are punished for past misconduct, then they will not mend their ways. This is particularly true with the IMF, which is the bailiff that enforces international debt repayments and ensures that it is repaid first, and with the World Bank, which continues to lend to notorious dictators in the belief that it can enforce payment.

Illegitimate lending is often political. During the Cold War loans were used to prop up dictators who were allies of the West. Today loans are being used

to prop up dictators who are allies in the 'war against terror' and the search for secure oil supplies. US financier George Soros said: 'I personally would be very happy to see the old creditors of Iraq not getting paid. That would send a signal to the financial markets that it's dangerous to deal with oppressive regimes'.[46] Does the international community agree, and want to prevent the recurrence of the lending excesses of the past, or does it want a new round of excesses to support its new allies?

Not surprisingly, the IMF continues to resist the concept of illegitimate debt. In a remarkable article, the Director of the IMF'S research department, Raghuram Rajan, accepts that lending to the apartheid regime in South Africa 'was doubly odious', but then says it was wise for the post-apartheid government to repay the debt. He goes on to argue that the international community should lend to dictators and odious regimes, because it would do more harm not to, on two grounds. First, if the international community does not lend to a greedy dictator, then the 'country could be worse off if the dictator stole through unusual channels', such as 'trafficking in antiques, endangered animals, wood and drugs . . . than if he stole by building up debt'. Second, international lenders would be afraid to lend to legitimate governments for fear of the debt being declared illegitimate.[47] It is a bizarre justification, which shows just how far the world of international banking has gone from that of domestic banking. In no country would banks argue that they should be allowed to lend to murderers, gangsters and drug addicts in order to reduce their criminal activities. And heavy restrictions on illegitimate lending, such as the British Consumer Credit Act 1974, have not brought legitimate lending to a halt; to the contrary, domestic bank lending continues to expand rapidly. Rajan's argument shows precisely why the experience of increased lender responsibility in domestic lending must now be applied to international lending.

The central purpose of setting out a concept of illegitimate debt is to argue that international lenders must accept some responsibility for their loans, just as domestic lenders do. It is to say that lending to notorious thugs, lending for corrupt purposes, and lending for foolish and damaging projects should be disciplined and prevented. By definition, financial institutions understand only one kind of penalty, and that is financial. They were able to lend to a regime practising apartheid, which had been defined as a crime against humanity, to Mobutu, knowing that he would steal the money, to Marcos for a project that could never be used—and they are getting their money back. What lesson does that teach the banker? Namely that any lending is possible. Such lending will be halted only if the international community says that illegitimate loans should not be repaid—that they are the responsibility of the lender, not the borrower—and that cancellation does not depend on the good conduct of the borrower but on the misconduct of the lender.

Notes

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9 World Bank, *Uzbekistan Country Brief*, at http://www.worldbank.org.uz. Despite a massacre of hundreds of protestors on 13 May 2005 and widespread press coverage of human rights violations, the World Bank had not amended its country brief when it was last accessed on 1 October 2005 and it still made no mention of human rights issues. The World Bank committed $75 million in new loans in 2002, when human rights violations were well known, followed by $60 million in 2003, $75 million in 2004, and $40 million in 2005.
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13 Adams *Odious Debts*, p 168.
14 AN Sack, *Les effets de transformations des États sur leur dettes publiques et autres obligations financières*, Paris: Recueil Soirey, 1927, translated from the French by P Adams and quoted by her in *Odious Debts*, p 165.
15 House of Commons International Development Committee, *Debt Relief*, 3rd Report 1997–1998, London: House of Commons, 1998, paras 11, 57.
16 On 28 October 2004 a British court cancelled a £384 000 debt and stopped the confiscation of a house on the grounds that the debt was 'extortionate', both on grounds of high interest rates and also because the borrowers were forced to take unacceptable conditions. *Guardian* and *Independent*, 29 October 2004.
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