It’s time we reconsidered the principle that states must always repay their sovereign debt

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Is it true that states must always repay their sovereign debt – even after a major regime change – to maintain their future creditworthiness? **Odette Lienau** *writes that this conventional wisdom on sovereign debt is overly simplistic and in some cases entirely wrong. She argues that the assumptions of political neutrality, creditor uniformity, and historical constancy, upon which this common narrative rests, do not stand up to closer inspection. This suggests that more flexibility exists in terms of our understanding of government debt and how the market determines creditworthiness.*

Conventional wisdom holds that all nations must repay debt. Regardless of the legitimacy of the regime that signs the contract, the actual use of loan proceeds, or the exigencies of any potential default, a country that fails to honour its loan obligations damages its reputation, inviting still greater problems down the road.

Yet difficult questions have arisen from this assumption: Should a black-African-led South Africa really be expected to repay apartheid era debt? Or, given that Saddam Hussein was a dictator who used funds for the oppression of a majority of Iraq’s population, would it be appropriate to require future Iraqi generations to pay for his iniquity? Although the strict repayment norm comes into starkest relief in situations of regime change and transitional justice, its expectations filter into debt negotiations more generally. If repayment is expected even in such extreme circumstances, then it is reasonable to expect debtors to bear most of the burden in all other situations as well.

Rethinking sovereign debt

My book, *Rethinking Sovereign Debt: Politics, Reputation, and Legitimacy in Modern Finance*, argues that the market narrative supporting the repayment norm is overly simplistic and in some respects entirely wrong. I suggest that the framing of repayment and reputation as a market principle immobilises our sovereign debt regime in part by propagating the following three assumptions.

First, the dominant approach implies that although creditors may assess a specific borrower’s political characteristics through the lens of sovereign risk, judgements about a borrower’s repayment decisions are not shaped by politics per se. Rather, they are simply the best objective assessment of a given set of material facts, and are therefore unchallengeable on the basis of political or moral principle. Second, the mechanism of sovereign reputation itself is assumed to be similarly free from subjective and historically variable political judgments, and therefore similarly immune from challenge. And third, all rational creditors are expected to respond in basically the same way to particular debt events, suggesting that efforts to understand or reshape their identities and interests would be futile.

But in fact none of these assumptions seem to hold up to closer scrutiny, which means that the strict debt repayment norm is more politically and historically variable than it first appears. To begin with, any discussion of sovereign debt is rendered intelligible *only* by quietly incorporating one of the most highly politicised (and thus deeply contested) terms in international law and international relations: “sovereignty.” Depending on the theory of sovereignty implicitly or explicitly adopted, the practices of sovereign debt and reputation could be expected to diverge significantly.

Furthermore, creditor uniformity cannot simply be assumed, and in fact different creditors may interpret – and historically *have* interpreted – the same politicised debt repudiation in opposing ways. The post-World War I cases of the Soviet Union and Costa Rica have been held out to suggest the futility of challenging the timeless rules of capital markets. But in fact these cases demonstrate quite the opposite, showing how creditors can reasonably make reputational judgements in favour of post-repudiation lending, at least under conditions of market competition

and ideological flexibility. The Soviet case in particular has been misinterpreted in the economics literature; a look at the historical correspondence between banks and governments, rather than only at bond float data, demonstrates that private interest *did* exist in lending to the new Soviet regime, at least among new American banks eager to compete with established European financiers.

The absence of similar cases later in the century was hardly embedded in apolitical market certainties or ahistorical creditor preferences. Rather, the departure from the more open post-World War I moment resulted from changing political structures and sovereignty norms, as well as from shifts in creditor interactions. The post-World War II reconstruction of the financial system was led by public creditors such as the new World Bank, which promoted sovereign debt practices that comported with their own financial and operational needs, including a strict insistence on debt repayment. When private creditors returned to sovereign lending in the early 1970s, they arrived through a framework of syndicated lending and multinational branching that undermined the space for heterodox creditor approaches and further consolidated a narrow repayment rule. Sovereign states themselves, increasingly wary of external scrutiny of their internal political and economic choices, hardly forced an open discussion of political principles in the debt arena.

This background affected the subsequent loan restructurings of the late 1970s and 1980s. In particular, the systemic risk posed by the private banks' interconnected loans – and the banks' interaction with public actors such as the IMF and the US Treasury – resulted in a joint approach to sovereign borrowers that limited the space for alternative approaches to debt. Thus, despite being grounded in very particular historical moments, these shifts granted the rule of debt repayment an air of inevitability into the 1990s, and meant that even clearly revolutionary governments in Nicaragua, Iran, the Philippines, and South Africa ultimately acknowledged the debts of their predecessors.

This is not at all to say that the story is over. If indeed a strict repayment rule has been shaped over the last century by political actors, broader ideological shifts, and changing public and private creditor structures – and if there are moments demonstrating how finance can function even in its absence – then it is hardly necessary for workable international capital markets. Alternative approaches, incorporating ideas of illegitimate debt and allowing for limited cancellation, emerged historically and could function more fully in the future.

Indeed, the post-Cold War era has witnessed the international move toward a discourse of governance, democracy, and human rights, which has made its way into the language (if not fully the practice) of even major economic organisations and private creditor groups. Although expectations of uniform repayment still dominate, new modes of creditor interaction and sources of international capital have further enabled flexibility in certain cases, and debt discussions in Iraq, Ecuador, and even Europe have brought arguments about illegitimate debt more to light.

Thus popular and scholarly discussions of sovereign debt have the potential to be much broader than their current contours imply. The norm of strict debt repayment is theoretically unstable and historically variable, and undermines any assumption of a uniform, apolitical, and basically unalterable creditor interpretation of debtor actions. Even in the absence of concerted effort by the international community, market actors have the requisite political intelligence to make reputational judgements that could countenance more flexible debt practices, including even debt cancellation in some instances. Challenging the assumption that strict debt payment is a market necessity, in part by understanding where it comes from, is a first step to more balanced discussions about the politics and prospects of sovereign debt in future years.

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