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# HOW TO AVOID THE REPETITION OF “ODIOUS” DEBTS?



# The Law and Political Economy of Mozambique's Odious Debt

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## A. Introduction

The topic of this paper is a complicated matter. Debt crises raise difficult questions of law, economics, politics, and morality.

Let me start with the latter category, morality. Our standards for the treatment of debtors have vary greatly across time and space. For instance, Jabez Hornblower, a distant ancestor of mine, was put to prison when his business for the production of steam engines failed after he lost a patent suit against James Watt.<sup>2</sup> Of course, spending time in prison did not help Hornblower to get rid of his debt. It made no sense economically, but it demonstrates the excruciatingly high moral value associated with the duty to repay one's debts. And the duty has often been so strong that it even allowed people to be enslaved.

On the other hand, there is a very old text which tells us that debt should be forgiven in certain intervals. Thus, we read in the Leviticus:

“And ye shall hallow the fiftieth year, and proclaim liberty throughout all the land unto all the inhabitants thereof: it shall be a jubilee unto you; and ye shall return every man unto his possession, and ye shall return every man unto his family.”<sup>3</sup>

Similar statements can be found in other religious texts.

For sovereign debt, the situation is even more complicated. Sovereign debt is not merely a risk, but often enough a chance and a necessity. At the same time, one cannot put the economic survival of a state at risk. States are the backbone of our present world order.

In recognition of this fact, Adam Smith, at least as much a moral philosopher as an economist, concluded:

“When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both the least dishonourable to the debtor, and least hurtful to the creditor.”<sup>4</sup>

Nevertheless, during the 19<sup>th</sup> century, a number of states experienced so-called acts of “gunboat diplomacy”. Great Britain, Germany, and Italy used their naval forces to block access to the ports of Venezuela, trying to compel her to repay her debts to the nationals of the intervening powers.<sup>5</sup>

Such enforcement of sovereign debt is especially problematic if a debtor state finds itself in an economic crisis in crisis – whether of a financial, political, economic, or social nature. The pressure stemming from sovereign debt has the potential to send a country into a downward spiral of austerity and further decline.<sup>6</sup> One of the worst examples in this regard is the debt crisis in Rwanda before 1994. Being a victim of the debt crisis in the global south in the 1980s, Rwanda imposed severe austerity measures

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<sup>2</sup> See [https://en.wikipedia.org/wiki/Jabez\\_Carter\\_Hornblower](https://en.wikipedia.org/wiki/Jabez_Carter_Hornblower).

<sup>3</sup> 3 Moses 25:10 (Leviticus).

<sup>4</sup> Adam Smith, *The Wealth of Nations* (2000 [1776]) 468.

<sup>5</sup> Miriam Hood, *Gunboat diplomacy 1895 – 1905. Great power pressure in Venezuela* (Allen & Unwin 1975) 163 et seq.

<sup>6</sup> Cf. Mark Blyth, *Austerity: The history of a dangerous idea* (Oxford University Press 2013), chapter 6.

upon its population to get access to much-needed multilateral lending. The austerity measures, for which the regime of Habyarimana earned praise from the International Monetary Fund, hit the country heavily. Production stagnated, not least due to a lack of investment, while its population continued to grow, becoming increasingly impoverished. This development increased the legitimacy crisis of the Habyarimana government, in power since decades. The government therefore diverted funds received as loans from multilateral institutions for arms purchases and the creation of a militia.<sup>7</sup> The tragic outcome is well-known.

Other countries received a more beneficial treatment. In 1953, creditors granted Germany generous debt relief. After the devastating experience of the Second World War, in the run-up to which sovereign debt accumulated as a consequence of the First World War had played not only an insignificant role, the creditor states did not want to repeat their mistake and granted Germany a second chance.<sup>8</sup>

This short review of only a few controversial cases amply demonstrates that sovereign debt is a complicated matter, implicating difficult choices relating to economics, politics, morality and ultimately questions of war and peace.

The thesis of this paper is a very simple one, though. Mozambique should not repay the loans which three of its state-owned enterprises took out in 2013-2014.<sup>9</sup>

I will provide two types of reasons for this conclusion. The first type is rather legal and straightforward (B.). The second type is of a more contextual character (C.). While the loans in question are void as a matter of law, they reveal certain characteristic traits of our current worldwide financial system, which I believe must be changed. An oversupply of liquidity in capital-rich countries may have devastating effects for capital-importing, developing countries. Not the interest of creditors, but the needs of lenders should determine sovereign lending.

## B. Legal Analysis

Broadly speaking, the reason why Mozambique does not need to repay the loans is that one needs to qualify them as “odious debts.” This term designates debt contracted by state agents against the needs and interests of the population.<sup>10</sup> From a legal standpoint, however, the concept is a rather controversial one with sometime unclear contours. Instead of operating with the concept of “odious debt”, I therefore prefer to disentangle the various reasons recognized under different legal orders which might lead to the invalidity of sovereign debt agreements. Three different legal orders have a bearing on this case: the perspective of English law, the law applicable to the loan agreements (1.);<sup>11</sup> the perspective of international law as it is applied by arbitral tribunals (2.); and the question under which conditions the International Monetary Fund (IMF) would recognize the invalidity of the

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7 Cf. Michel Chossudovsky and Pierre Galand, “The 1994 Rwandan Genocide - The Use of Rwanda’s External Debt (1990-1994). The Responsibility of Donors and Creditors.” CADTM Website, 7 April 2016, <http://www.cadtm.org/The-1994-Rwandan-Genocide-The-Use>.

8 See Marc Jacob, London Agreement on German External Debt (1953), in R. Wolfrum (ed.), *Max Planck Encyclopedia of Public International Law* (2013).

9 For full details, see Kroll, Independent Audit Related to Loans Contracted by ProIndicus S.A., EMATUM S.A. and Mozambique Asset Management S.A., prepared for The Office of the Public Prosecutor of the Republic of Mozambique, 23 June 2017.

10 Cf. Alexander N. Sack, *Les effets des transformations des états sur leurs dettes publiques et autres obligations financières* (Sirey 1927); see also Robert Howse, *The Concept of Odious Debt in Public International Law*, UNCTAD Discussion Paper (2007) [http://unctad.org/en/Docs/osgdp20074\\_en.pdf](http://unctad.org/en/Docs/osgdp20074_en.pdf).

11 Cf. Relatório da Comissão Parlamentar de Inquérito para Averiguar a Situação da Dívida Pública, 30 November 2016, p. 36-7.

disputed loans (3.).

I base the following analysis on the assumption that there have been acts of corruption, as stated in the indictment of the New York case.<sup>12</sup> Of course, every accused is entitled to the presumption of innocence until proven guilty.<sup>13</sup> The following analysis, however, is not about the criminal responsibility of the accused in this case, but about the liability of Mozambique for the debt in question.

## 1. English Law

Since each of the three loans was concluded under different, particular circumstances, it seems apposite to discuss them separately in chronological order.

### a) Proindicus

As a matter of contract law, the Proindicus loan does not need to be repaid. Under English law, the loan agreement is void. This result derives from the doctrine of illegality. Accordingly, a claim may not arise from an illegal or dishonorable act (“ex turpi causa non oritur actio”).<sup>14</sup> This principle enjoys almost universal recognition.<sup>15</sup> Corruption of foreign officials is illegal under Section 6 of the 2010 UK Bribery Act. Also, the failure of an enterprise to put in place adequate mechanisms for the prevention of bribery is a criminal offense under Section 7 of the 2010 UK Bribery Act. The Indictment<sup>16</sup> and the independent audit of the three loan agreements carried out by Kroll (Kroll report)<sup>17</sup> amply demonstrate how the acting individual could easily overcome the internal controls of Credit Suisse; they were clearly insufficient. While the UK Bribery Act does not directly invalidate contracts arranged by bribes, such contracts are illegal under the common law doctrine of illegality.<sup>18</sup> The loan agreement is therefore void. In comparable cases, courts have also held that contracts arranged through bribery do not fall within the “ostensible authority” of state agents and are therefore to be qualified as ultra vires acts.<sup>19</sup>

What are the legal ramifications of the contract’s invalidity? In particular, does Credit Suisse have the right to claim that Mozambique was unjustly enriched by the payments under the loan agreement and needs to pay back the sums received?<sup>20</sup>

I believe the answer is no. This follows from the landmark judgment of the UK Supreme Court of 2016, the case *Patel v Mirza*. It defines the requirements for the illegality defense against claims of unjustified enrichment. Accordingly,

12 U.S. District Court EDNY, Case 1:18-CR-00681-WFK, indictment filed on 3 January 2019.

13 This presumption is established in domestic law and follows from international human rights law, cf. Art. 14.2 ICCPR.

14 This doctrine dates back to *Holman v Johnson* (1775) 1 Cowp 341 (Mansfield CJ). It is substantially identical with the doctrine “ex dolo malo non oritur actio”.

15 Jeff King, *The Doctrine of Odious Debt in International Law: A Restatement* (Cambridge University Press 2016) 111 et seq. See also art. 1.4 of the Unidroit Principles, <https://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2010/414-chapter-1-general-provisions/866-article-1-4-mandatory-rules>. This provision explicitly refers to breaches of international law such as the UN Anti Corruption Convention.

16 *Supra* n 11.

17 Kroll (n 8).

18 Cf. *Ochroid Trading Ltd v. Chua Siok Lui*, [2018] SGCA 5, para. 35.

19 King (n 14) 113, 115.

20 Cf. *Lipkin Gorman v Karpnale Ltd*, [1991] 3 WLR 10.

“The essential rationale of the illegality doctrine is that it would be contrary to the public interest to enforce a claim if to do so would be harmful to the integrity of the legal system (or, possibly, certain aspects of public morality, the boundaries of which have never been made entirely clear and which do not arise for consideration in this case). In assessing whether the public interest would be harmed in that way, it is necessary a) to consider the underlying purpose of the prohibition which has been transgressed and whether that purpose will be enhanced by denial of the claim, b) to consider any other relevant public policy on which the denial of the claim may have an impact and c) to consider whether denial of the claim would be a proportionate response to the illegality, bearing in mind that punishment is a matter for the criminal courts. Within that framework, various factors may be relevant, but it would be a mistake to suggest that the court is free to decide a case in an undisciplined way. The public interest is best served by a principled and transparent assessment of the considerations identified, rather by than the application of a formal approach capable of producing results which may appear arbitrary, unjust or disproportionate.”<sup>21</sup>

The judgment gives wide discretion to English courts, making the outcome of a case notoriously difficult to predict. Much depends on the particular circumstances of the case and whether the denial of a claim for unjustified enrichment would further public policy.

Applying these criteria, it follows that Mozambique does not need to repay Credit Suisse. The purpose of the prohibition of corruption is twofold, at least to the extent that it is relevant for the case at hand. On the one hand, the prohibition is meant to ensure the integrity of the market and guarantee fair competition. On the other hand, as Section 7 of the 2010 UK Bribery Act underscores, it has the function of protecting the public interest and specifically the public purse. It is particularly the latter purpose which would be harmed if Mozambique had to repay the Proindicus loan. The fact that large parts of the funds seem to have disappeared is a typical risk associated with corruption; the public purse deserves particular protection from this risk. An important additional policy consideration concerns prevention. In this regard, the connivance of employees of Credit Suisse plays an important role. Financial institutions had few incentives to prevent and reprimand such behavior and exercise due diligence if they could reclaim the full amount of the loan on the basis of unjustified enrichment and bore a low risk. The ensuing result is proportionate to the weight of the rules which have been violated. Denying repayment does not amount to a double punishment. Rather, the question is who should bear the risk that the funds disappear. This should be the party who is best positioned to protect herself against the risk. In this case, Credit Suisse failed to exercise due diligence. The audit of the three loans and the indictment in the United States reveal that no proper business plan existed for the state-owned enterprises, that tendering processes did not take place, and that the contractor, who received the funds, was notorious for improper transactions.<sup>22</sup> The complete failure of Credit Suisse to exercise due diligence justifies imposing the risk of a loss of the investment on it. Denying the claims of Credit Suisse would not amount to a “free lunch” for Mozambique. Rather, Mozambique is not enriched any longer. The proceeds from the loan have disappeared. Repayment, even in part, would strip Mozambique of much-needed funds to fulfil basic human rights obligations.<sup>23</sup> In fact, the

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<sup>21</sup> *Patel (Respondent) v Mirza (Appellant)*, [2016] UKSC 42, para. 120 (Toulson LJ).

<sup>22</sup> Kroll (n 8); for the indictment see n 11, especially at 13.

<sup>23</sup> On these obligations, see Human Rights Council, Guiding principles on human rights impact assessments of economic reforms, Report of the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the

discovery of the EMATUM loan and subsequent discontinuation of IMF funding in April 2016 led to incisive budgetary reallocations from social services and the judiciary to debt service, amongst others.<sup>24</sup>

It might, however, be possible that a court decides to reject a claim for unjustified enrichment only to the extent that Mozambique demonstrates good faith efforts to prosecute its officials involved in the fraudulent scheme, and to freeze their assets to enable creditors of the suspects, including the banks involved, to recover at least some of their assets.

## b) EMATUM

Analyzing the EMATUM transaction is more challenging. At the outset similar considerations apply to the initial loan agreement. It was illegal because it violated the prohibition of corruption. One of the employees of Credit Suisse involved in the fraudulent scheme signed the agreement on behalf of the bank.<sup>25</sup> The loan participation notes issued by Credit Suisse on the basis of the loans were therefore void, too.

Claims based on the initial loan, or loan participation notes, would have had to be denied on the basis of the doctrine of illegality as defined in *Patel v Mirza*. The situation is similar to the one of the Proindicus loan. First, the purpose of the prohibition of corruption calls for this result. Securitization must not allow a financial institution to validate an initially void claim. This would enable them to avoid exercising any reasonable due diligence with regard to the possibility of corruption. They need to face issuer liability; otherwise the prohibition of corruption loses much of its teeth. Criminal liability requires high standards, including evidence for *dolus malus*, and are not equally effective.

Second, this result is proportionate to the purpose of the prohibition. Credit Suisse would have had ample reason to be careful in the case at hand. Even if two individuals formerly working for Credit Suisse tried to hide their involvement in the EMATUM transaction, the similarity of the two transactions would have given Credit Suisse ample reason to be suspicious. Considering the volume of the initial loan, the surprising brevity of the prospectus for the EMATUM loan participation notes and the complete secrecy<sup>26</sup> of the loan agreement before Credit Suisse offered the notes constitute further indicators for the impropriety of the transaction. The result would not have disproportionately affected the holders of the notes as they were protected by issuer liability of Credit Suisse.

The particular difficulty surrounding the EMATUM bonds, however, arises from the fact that Mozambique restructured the original loan participation notes in 2016 and exchanged them for Eurobonds, in what seems to have been a rather rushed process.<sup>27</sup> Are restructured agreements unaffected by the illegality of the original loan? The doctrine of novation seems to suggest that as a

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full enjoyment of human rights, particularly economic, social and cultural rights, UN Doc. A/HRC/40/57 of 19 December 2018.

24 Cf. the letter sent by i.a. the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights to the government of Mozambique, 25 August 2016, on file with the author.

25 Indictment (n 11) at 20.

26 See the summary of the report by the Parliamentary Commission of Inquiry, 13 February 2017, available at [http://www.open.ac.uk/technology/mozambique/sites/www.open.ac.uk.technology.mozambique/files/files/Mozambique\\_359-13Feb2017\\_\\$2bn-debt-parliamentary-report-key-points.pdf](http://www.open.ac.uk/technology/mozambique/sites/www.open.ac.uk.technology.mozambique/files/files/Mozambique_359-13Feb2017_$2bn-debt-parliamentary-report-key-points.pdf), p. 5.

27 Joseph Cotterill, *So Long, and Thanks for All the Tuna Bonds*, FT Alphaville, 11 March 2016, <https://ftalphaville.ft.com/2016/03/11/2156022/so-long-and-thanks-for-all-the-tuna-bonds/>.

matter of principle, the validity of old debt cannot affect the validity of new debt exchanged for the former.<sup>28</sup>

However, I have doubts about this result, which stem from the decision in *Patel v Mirza* and the test established therein. I will distinguish two scenarios. The first assumes that the restructuring involved another round of bribes and kickbacks, the second scenario does not make this assumption.

As to the first scenario, I assume that the restructuring as such may have been improper and tainted by corruption. This is not hypothetical. On the one hand, its immediate purpose was to allow Mozambique to regain access to IMF funding. On the other hand, there are indications that the restructuring may have been improper. The restructuring was carried out in a rush,<sup>29</sup> explanations given in parliament about the government guarantee seem to have been insufficient. Once again, the loan agreement involved egregious fees amounting to no less than 31m USD. In addition, there is no information on the use of the funds, and the audit discovered discrepancies between sums owed under the restructuring conditions and sums paid.<sup>30</sup> Also, the involvement of the same persons in the restructuring that had played a role in the arrangement of the invalid loans and the setup of the scheme of corruption provides reasons for the assumption that there has been impropriety in the restructuring operation.<sup>31</sup>

Of course, the foregoing assumptions have not been proven. Should they be proven, however, the *Patel v Mirza* test needs to be applied. Does the purpose of the prohibition of corruption call for a rejection of claims on the basis of the restructured bonds? To answer this question, one has to weight the importance of the prohibition of corruption against concerns for legal certainty, including the legitimate expectations of the bondholders. Bondholders normally need to be able to rely on the validity of their security.

I think that even if the bondholders did not participate in the fraudulent schemes and can only be blamed for failing to recognize them, the fight against corruption cannot allow a bank to “wash” tainted loan agreements via restructurings, which continues and entrenches the corruption rather than resolving it. Indeed, the courts would create a huge incentive for protracted corruption if a restructuring, although involving bribes, could purify an original illegal agreement resulting from previous acts of corruption. This would devise a risk-free strategy for banks to take a “soft” approach to compliance and fail to exercise due diligence, and for state officials to seek even more bribes. This result would be proportionate as the funds have disappeared and the people of Mozambique, one of the poorest nations, would otherwise have to repay the debts, risking its chances to development and the realization of human rights. Again, a court might grant Mozambique the illegality defense only to the extent that Mozambique can provide evidence of her sincere, sustainable efforts to prosecute those responsible and freeze their assets. By contrast, the bondholders, to the extent that they were of good faith and did not have reason to be suspicious, are protected under the rules relating to prospectus liability.<sup>32</sup>

<sup>28</sup> King (n 14) at 186-188.

<sup>29</sup> Cotterill (n 26).

<sup>30</sup> Kroll (n 8) at 27 et seq.

<sup>31</sup> Cf. Indictment (n 11) at 30.

<sup>32</sup> Rule 90, UK Financial Services and Markets Act 2000.



As concerns the second scenario, even if it cannot be proven that the restructuring as such was improper and imbued by bribery, there is reason to doubt the validity of the restructuring. One has to read it in the context of the preceding loan agreement, which was illegal without any doubt. That illegality was known to the parties, or to the persons acting for them. The debt restructuring seems to have been carried out to aid and abet the fraudulent scheme surrounding the original loan agreement, especially by preventing intriguing questions from concerned investors and allowing the persons involved to keep their illegal financial benefits. In accordance with the principles set out by the majority in *Patel v Mirza*, a claim for unjustified enrichment on the part of the bondholders might even be excluded in this scenario. Again, it is necessary to prevent a circumvention of the original prohibition by way of a restructuring. A restructuring cannot cure the stigma of corruption. In fact, the restructuring allowed the parties involved, the government of Mozambique and the underwriting banks Credit Suisse and VTB, to continue the fraudulent scheme. The prohibition of bribing foreign officials reflects a transnational public interest.<sup>33</sup> International commerce cannot flourish when the self-interested acts of market participants and corrupt state officials distort the market, produce unfair competition, and put the financial health of states at risk. Denying their claims might sound harsh for the bondholders and raise questions of legal certainty, especially as the illegality in this case relates specifically to the original loan agreement and not (also) to the restructuring. But upon closer scrutiny, the result does not seem to be disproportionate. The bondholders exchanged worthless loan notes into equally worthless Eurobonds. When buying the loan notes, they were not put off by the shortness of a three-page prospectus for a multimillion dollar project.<sup>34</sup> Further, the bondholders are protected by the principles of prospectus liability and may claim compensation from underwriters and agents involved in the deal. By contrast, should the bonds be considered valid or a claim for unjustified enrichment be granted, the people of Mozambique would have to bear the costs, including their human rights impact as mentioned before.

The result is therefore the same for both scenarios. In each case, the distribution of losses that would have applied had the EMATUM loan not been restructured would be preserved. The invalidity of the original loan rendered the original loan notes void. Without the 2016 restructuring of the EMATUM loan, the holders of the notes may have sued the underwriting banks, which had packed the loan into bonds.

There are precedents supporting this position. In these cases, courts held a loan to be void, which was used to pay debts resulting from an illegal transaction the parties knew to be illegal.<sup>35</sup> These cases differ from the present one insofar as they do not involve securities; hence the illegality was known to the parties directly. In the case at hand, the illegality at least of the original loan agreement was known, or could have been known, to agents acting for Mozambique, and persons acting as arrangers. Nevertheless, this difference is typical of the issuance of securities, which rarely involve the ultimate buyer directly. *Patel v Mirza* allows making such policy considerations.

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33 See the case *World Duty Free v. Kenya*, ICSID Case No ARB/00/07, Award, 4 October 2006 (more on this case below in n 45 and accompanying text).

34 Cotterill (n 26).

35 *Spector v Ageda*, [1973] Ch 30; for further references, see *Donegall International Ltd. v Zambia*, 2007 WL 504688 (2007) para. 481.

If the restructured bonds are void, the question of liability under securities law arises, which I have mentioned before. Under the terms of European securities law as implemented in the United Kingdom, issuers of bonds face liability if the prospectus of the new bonds contained false allegations or omitted material facts. The prospectus said nothing about the corruption which I take to lie at the origin of the EMATUM bonds. Also, it appears that former members of the government of Mozambique knew about the fraudulent scheme.<sup>36</sup>

In my view, the illegality doctrine also needs to exclude the prospectus liability of the issuer.<sup>37</sup> It is settled case law and one of the rationales underpinning *Patel v Mirza* that the one hand cannot take what the other hand grants. The law needs to be free from contradictions.<sup>38</sup> It is therefore necessary that securities law and the law relating to market integrity and corporate governance does not pull on opposing strings.<sup>39</sup>

By contrast, prospectus liability should apply as defined in the statute for underwriters and other experts guaranteeing the response. In the case at hand, Credit Suisse and VTB formed a consortium for the restructuring. It seems possible that liability might arise from their role in this, given in particular that the compliance department of Credit Suisse repeatedly failed to properly exercise due diligence and stop the taking of the loans.

As an intermediate result, I conclude that Mozambique does not need to repay the bonds issued in exchange for the original EMATUM bonds. As a caveat, I have to add that this conclusion depends on the application of the *Patel v Mirza* test, which is still difficult to predict.

### c) MAM

The third transaction, the so-called MAM loan, differs from the Proindicus loan in that there is no evidence up to now that employees of VTB were directly involved in acts of corruption. Of course, VTB was not new to the business when the third loan was negotiated. But whether there will be sufficient evidence to prove an offence in the sense of the 2010 UK Bribery Act is not certain. A smoking gun has not (yet) been found. VTB might have failed to exercise due diligence. For example, the MAM loan does not seem to have been based on a realistic business plan with appropriate projections, and the meagre invoices provided for this multi-million dollar project throw a bad light on the entire transaction. Nevertheless, in the absence of further evidence, courts might conclude that VTB's failure to exercise due diligence with regard to the MAM loan was less serious. They might therefore consider it disproportionate to apply the illegality doctrine and deny a claim for unjustified enrichment.

Be this as it may, there is another reason why Mozambique does not have to pay back this loan. The official guarantee was illegal because the former finance minister who signed the guarantee did not

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36 Cf. Financial Services and Markets Act 2000 (FSMA), section 90, Schedule 10.

37 Financial Services and Markets Act 2000 (FSMA), section 90 and section 90A.

38 *Patel v. Mirza*, para. 95 et seq.

39 The U.S. Congress tends to use securities legislation to further corporate governance issues, cf. A. C. Pritchard, Corporate Governance, Capital Markets, and Securities Law, in *The Oxford Handbook of Corporate Law and Governance* (J.N. Gordon and W.-G. Ringe eds., 2015). In Pritchard's view, this tendency is not without downsides, of which the major seems to be a flight from U.S. listings. This trend, however, would be countered most effectively by adopting international standards rather than by scaling back the support which securities law may lend to corporate governance issues.

have the authority to do so. Art. 179 (1) (p) of the constitution of Mozambique reads:

“The national assembly has exclusive power to authorise the Government, while defining the general conditions, to contract and make loans and to carry out other credit transactions, for periods exceeding one financial year, and to establish the upper limit for guarantees that may be given by the State; ...“

The budget laws for 2013 and 2014 put a narrow ceiling on state guaranties, restricting them to ca. 6.5m USD per year. The issued guaranty for the MAM loan exceeded this amount by far. The use of emergency powers cannot be justified as there was no pressure to issue the guaranty. Hence, this guaranty violated the constitution.<sup>40</sup>

Such a lack of authority leads to the invalidity of the guaranties, unless Mozambique made representations that may have led VTB into believing that the persons signing the guaranty on behalf of Mozambique had ostensible authority. An important precedent in this respect is a 2017 judgment of the High Court for England and Wales in a case in which Ukraine claimed that bonds purchased by Russia violated its constitutional debt limit.<sup>41</sup> The court considered it as a factual matter whether Ukraine had ostensible authority. In this respect, the prospectus issued by Ukraine claimed that the finance minister signing the bonds had the authority to do so. Also, the trustee involved in the issuance of the bond had previously acted in this role in no less than 31 public bond issuances carried out in the same way. In none of these cases, there was a problem with authority.

The case of Mozambique is quite different. There was no prospectus for the MAM loan. The entire operation was not public. That alone should have made VTB suspicious. It is common practice around the globe that loans or guarantees require parliamentary approval.<sup>42</sup> The 2012 UNCTAD Principles for Responsible Sovereign Lending and Borrowing urge lenders to ensure that sovereign debt is properly authorized under the law of the state in question.<sup>43</sup> Also, there is a comparable case from the United States. The Federal Control Board overseeing Puerto Rico’s debt recently stated that debts incurred in violation of Puerto Rico’s constitutional debt limit was invalid.<sup>44</sup>

There are therefore important reasons to believe that the MAM loan is as invalid as the two other loans previously discussed. Consequently, under English law, Mozambique is not obliged to repay the loans taken out by the three state-owned enterprises.

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40 Cf. Club of Mozambique, Government broke the law, accuses Commission of Inquiry – AIM report, 12 December 2016, <https://clubofmozambique.com/news/government-broke-law-accuses-commission-inquiry-aim-report/>.

The report of the Parliamentary Commission of Inquiry, including an English summary, is available at <http://www.open.ac.uk/technology/mozambique/mozambique-government-documents>.

41 Law Debenture Trust Corp Plc v Ukraine, [2018] 3 W.L.R. 667 (2017).

42 See Matthias Goldmann, *Responsible Sovereign Lending and Borrowing: The View from Domestic Jurisdictions. A Comparative Survey* (2012), available at <http://unctad.org/en/Pages/GDS/Sovereign-Debt-Portal/Sovereign-Debt-Workout-Mechanism.aspx>, p. 20.

43 Principle 3, UNCTAD Principles on Responsible Sovereign Lending and Borrowing, available at [https://unctad.org/en/PublicationsLibrary/gdsddf2012misc1\\_en.pdf?user=46](https://unctad.org/en/PublicationsLibrary/gdsddf2012misc1_en.pdf?user=46).

44 Brian Chappatta, Puerto Rico Tests the Trump Strategy to Wipe Out Debt, Bloomberg, 15 January 2019, <https://www.bloomberg.com/opinion/articles/2019-01-15/puerto-rico-attempts-trump-strategy-to-wipe-out-debt>.

## 2. International Law

Let me turn to international law. You may wonder why this is important. Indeed, there is the possibility that the creditors sue Mozambique before an international investment tribunal. Mozambique has concluded bilateral investment treaties with a number of countries, among them Switzerland and the United Kingdom.<sup>45</sup> These agreements contain standardized, boilerplate language defining the rights and duties of the parties. In particular, unlike more recent agreements, they do not contain provisions excluding sovereign debt from their scope. Therefore, the bad news is that the creditors of the three transactions in question might sue Mozambique before an international investment tribunal.

The good news is that their chances to win their case are minimal. Investment tribunals do not enforce investments in which bribery was involved. This is a rather straightforward matter. Investment tribunals apply the rules of general international law.<sup>46</sup> Corruption is illegal under various international instruments, particularly the UN Convention Against Corruption. Mozambique acceded to this convention in 2008, and the UK, Switzerland, the Emirates, and Russia are also members.

For investment tribunals, this has the consequence that transaction involving corruption cannot be enforced. The leading case in this respect is *World Duty Free v. Kenya*.<sup>47</sup> In this case, the claimant had acquired a concession for Duty Free shops in Kenya by handing over 2m USD in bribes to former Kenyan president Daniel arap Moi. The tribunal found that his act of bribery was violating Kenyan law and transnational public policy.<sup>48</sup> The tribunal established the existence of a transnational public policy by way of an extensive review of domestic and international case law, conventions, and declarations.<sup>49</sup>

As a consequence, the tribunal referred to the “*dolo malo*” doctrine (the illegality doctrine). Even though in the case of *World Duty Free* it had been the Kenyan President himself who, as the parties agreed, solicited and accepted the bribe, the need to protect the public interest and to fight corruption required considering the contract as void and dismissing the claims.<sup>50</sup>

Furthermore, international law also recognizes the nullity of debt agreements for lack of authorization to issue debts, or, which would be the same, official credit guarantees. The leading case in this respect is the *Tinoco* arbitration award of 1923.<sup>51</sup> The short-lived government of Tinoco had borrowed substantial amounts from British banks. The proceeds were diverted to private accounts of Tinoco and his brother, who shortly after fled the country. Britain sued Costa Rica before an arbitral tribunal established under an international treaty. The tribunal rejected Britain’s claim, because the whole transaction was irregular, a fact which the bank extending the loan could have known. For instance, the law provided that only the national bank could act as a depositary of a credit fund of the government,

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45 Full list at <https://investmentpolicyhub.unctad.org/IIA/CountryBits/143>.

46 See Art. 42 para. 1 of the ICSID convention. Accordingly, investment tribunals apply the rules agreed between the parties, and, lacking such rules, any rules of international law that may be applicable.

47 *World Duty Free v Kenya*, ICSID Case No ARB/00/07, award, 4 October 2006.

48 *Ibid.*, para. 170 et seq.

49 *Ibid.*, para. 138-157.

50 *Ibid.*, 181.

51 *Costa Rica v GB*, (1923) 1 RIAA 369.

not the British bank.<sup>52</sup> Thus, irregularities in the transaction void a loan.

Here, by virtue of article 179 of the constitution of Mozambique, VTB could have known that the guarantees needed to fall within the limit established by Parliament, and failed to verify this fact. The consequence is that Mozambique does not need to pay under international law.

### 3. Consequences for IMF Lending

As a practical matter, Mozambique can only rescind its odious debt for the reasons set out above if the IMF accepts this step. Otherwise, should the IMF consider the rescinded debt to be in default, instead of being invalid and therefore non-existent, Mozambique will not regain access to IMF funding.

Access to IMF funding, by the way, is the reason why Mozambique sought to restructure the EMATUM loan in 2016. The outcome is well-known. A typical example of an unsustainable restructuring. It only buys a little time – but does not grant substantial debt relief. Of course, for financial institutions, avoiding a reduction of the nominal amount of the debt is attractive as it allows them to escape a write-down (unless the debt instrument is in the trading book). The book value of the debt remains the same.

The reason for the IMF to avoid a clear position on the odious character of Mozambique's debt is its political neutrality. Would the IMF take a more pro-active position, urging governments to rescind illegal debts, the fear is that the private sector would react adversely and the IMF would lose credibility.

Nevertheless, there is a solution. In the 1980s, the IMF adopted a policy on disputed loans.<sup>53</sup> Accordingly, disputes about validity remove the item from the fund's jurisdiction. The IMF is thus trying to avoid a position by invoking the limits of its mandate. As a consequence, the ball is in the field of the debtor state. Under the IMF disputed loans policy, debtor states need to invoke the invalidity of the debt. The IMF will then take this representation as having been made in good faith. However, the IMF retains the right to conclude that the representation is clearly without merits.<sup>54</sup> There is thus a rebuttable presumption that the debt is invalid.

For Mozambique, this means that it has to notify the IMF that it considers the three loans in question as null and void, for the reasons stated above. To underscore its good faith and demonstrate the disputed nature of the claim, there are several options.

One option is to sue the companies and individuals who connived this scheme of bribery and corruption. Mozambique has taken a first step by filing a suit against Credit Suisse in London. It might be more difficult to sue VTB as no evidence seems to exist at this time proving its involvement in the scheme. Neither the indictment filed in the United States, nor the Kroll report contain any information to that effect.

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<sup>52</sup> Ibid., at 394.

<sup>53</sup> IMF, *The Role of the Fund in the Settlement of Disputes Between Members Relating to External Financial Obligations*, 25 April 1984.

<sup>54</sup> Ibid., at 8.

Apart from suing Credit Suisse, Mozambique should also bring charges against the individuals involved in this scheme and hold them liable, both civilly and criminally. Moreover, it should use the diplomatic channel to obtain a timely freeze of their foreign assets and bank accounts. This might help to recuperate part of the proceeds of their deeds.

As a side note, allow me the remark that I believe the IMF has good reasons to give up its position of alleged neutrality. First, that neutrality has never been real – it has been a policy in favor of the status quo, i.e. in favor of illegitimate debts. Second, the idea of neutrality stems from the last decade of the Cold War. Since this period, the IMF has been all but neutral when it comes to the domestic policies of the member states. As concerns corruption, the IMF is all but neutral and urges member states to take effective measures against it. This is the main message of the IMF's new anti-corruption framework of April 2018. It includes "governance weakness" issues, including problems with corruption, in the IMF's surveillance routine, and provides that conditionalities for lending should include measures to address governance vulnerabilities.

In light of this, it seems difficult to believe that taking a stand on odious debt would violate the IMF's political neutrality. In its relationship to the member states, such political neutrality is a thing of the past.

## C. The Political Economy behind the Loans

This part will expand the scope of the paper beyond the black letter of the law. So far, one might wonder whether it is really justified that Mozambique should not repay the loans. After all, its very own officials, including perhaps even members of the government, seem to have benefited from systematic corruption in this case. However, it takes two to tango. International lenders, whether directly involved in acts of bribery or not, also have a responsibility.

### 1. Loan Pushing

Why do well-established banks, such as Credit Suisse and VTB, extend loans of doubtful economic value, and fail completely in exercising their due diligence? To explore this question more profoundly, let's put the issue of corruption aside for a moment. This will reveal that these three loans highlight an important trend in international financial markets, namely increasing financial flows from the Global North to the Global South.

Financial flows as such do not need to have a negative effect as such. To the contrary, investments in the global south can be positive. Take the example of Mozambique. After a devastating past, Mozambique is still in the process of catching up and improving its infrastructure. However, the funds proceeding from the three loans were not used for a productive purpose like that. Even the business plans provided as a cover story seemed unrealistic and full of widely exaggerated projections.

How then to explain such careless, negligent investments? How to explain why the compliance management of Credit Suisse did not look more closely at the fundamentals of the loans? Why did

no-one cast into doubt the unrealistic assumptions underlying the projections for the three State-Owned Enterprises?

I believe that this incidence reveals the corrupting power of an oversupply of finance. The current oversupply has a lot to do with the global financial crisis of 2007/2008. As is well-known, it severely hit the banking sector in the developed world. The consequences can be felt until today. One of them is that the European banking sector has lacked profitability since then. The causes are manifold:

- Tighter regulation requires banks to step up their capital;
- Consistently low interest rates and generous lending windows of central banks reduce margins in the financial sector;
- Many banks still have non-performing loans in their books, especially in the ailing regions of the European economy;
- Increasing digitalization and automation in the financial sector challenges the cost structure of traditional banks;
- The investment sector, such as the market for structured products, is only recovering after it lost much credibility during the crisis.

In short, European banks often lack a solid business model. As a consequence, they make investments where they get a higher rate. One place for this seems to be the Global South, particularly Africa.

At this point, some might object and claim that market forces ultimately determine the allocation of finance. However, finance is a tightly regulated market, characterized by constant interventions of monetary and supervisory authority. The excesses of liquidity in the European financial system and the lack of a sound banking sector are the results of political choices. This is likely to lead to market distortions.

The market distortion one can see at work here is the following one: To a considerable extent, financial investments in Africa seem to be driven by supply rather than by demand. Not economic fundamentals, not the prospect of an attractive investment in a country with huge growth potential drive investments, but interest rate differentials – which result to an important extent from political choice. This is also called loan pushing.<sup>55</sup>

Such investments are highly likely to lead to unsustainable debt bubbles. As long as the interest rate differential exists, there is little incentive to look at the economic fundamentals of a transaction. This applies particularly to systemically important institutions like Credit Suisse, which can comfortably rely on a government guarantee. Once the interest differential turns, conditions for borrowers rapidly deteriorate. The rollover becomes rather difficult, even for legitimate borrowers, and the bubble bursts. In this situation, the creditors might face some losses, but certainly not existential ones. Western governments will suppress further market turmoil and are likely to bail out institutions at risk. But who will help the borrowers, who will help Mozambique? They will be left at the mercy of their creditors and the IMF, where the capital-exporting countries hold the majority.

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<sup>55</sup> Joseph Hanlon, “Debt & Development”, in Paul Haslam, Jessica Schafer, and Pierre Beaudet (eds.), *Introduction to International Development*, 2<sup>nd</sup> ed. 2012, ch. 14.

The scenario I describe is not hypothetical. Rather, the risk of a new debt crisis in Africa is a very real one. Despite impressive growth rates, lending in the past years has been excessive.<sup>56</sup> It is about to wipe out decade-long efforts towards debt reduction, especially in the frame of the HIPC and MDRI initiatives.

A debt crisis might be particularly severe since the inflow of capital has transformed the economies of developing and emerging economies considerably. This might create particular risks and potential crisis triggers. Again, Mozambique provides a striking example. Much of the recently imported capital – particularly in the private sector – flows into the development of extractive industries, especially gas. This slowly transforms Mozambique’s economy from one based on agriculture, coal, and aluminum, to one dependent on gas (and oil to a lesser extent). The downside of this transformation is a new dependency on the price of gas. Should this price go down, for whatever reason, crisis might quickly spread.<sup>57</sup>

Another, related risk with the move to extractive industries is the so-called “Dutch disease”. Profits from gas might cause the local currency to appreciate. This would make other sectors of the economy less competitive and ultimately go out of business. In case of Mozambique, I think particularly of tourism, which certainly has great potential and might become a motor for job creation. Once a crisis hits, an economy that is heavily dependent on one sector will have difficulty in adjusting. A declining exchange rate only helps in the long run, because new, more competitive sectors need time to build up.

This is not to say that there should be no extractive industries. A country has the right to exploit its resources. But this should be driven by a country’s objectives for sustainable development, not by international financial flows.<sup>58</sup>

## 2. The Corrupting Power of Liquidity Oversupply

Let me take one further step back and reflect on these financial flows from the north to the south in historical perspective. I believe that the current predicament of the Global South reveals a repeat pattern of global capitalism that can be observed in many instances since the earliest period of colonialism. This part develops a narrative about the externalities of a financialized economy, about how the oversupply of finance thwarts development and creates dependence, whether in the form of colonialism or present-day substitutes. For this purpose, I will review a few cases spanning over a couple of centuries. In each case, legal innovation played a crucial role for making finance available and creating dependence.

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56 Cf. Club of Mozambique, Africa’s New Sovereign Debt Crisis, 24 March 2017, <https://clubofmozambique.com/news/africas-new-sovereign-debt-crisis/>.

57 Instructive on Mozambique’s situation is the 2016 IMF report: IMF, Republic of Mozambique: Staff Report for the 2015 Article IV Consultation, Fifth Review Under the Policy Support Instrument, Request for Modification of Assessment Criteria, and Request for an 18-Month Arrangement Under the Standby Credit Facility-Press Release; Staff Report; and Statement by the Executive Director for Republic of Mozambique; Country Report 16/9, 8 January 2016, <http://www.imf.org/external/pubs/cat/longres.aspx?sk=43588.0>.

58 On the need for a holistic approach to development finance, see Kevin E. Davis, “Financing Development as a Field of Practice, Study and Innovation.” *Acta Juridica* (2009): 168.



I will begin with the Spanish and Portuguese colonization. At the bottom, this is a simple story. European surplus capital funded colonization. The emergence of the first territorial states in Europe in early modernity coincided with, and was influenced by, new funding structures. A group of merchants had accumulated considerable wealth by organizing long distance trade, opening new markets. Some of them, like the Fugger family from southern Germany, lend their surplus capital to sovereigns who sought to increase their power and wealth by exploring parts of the world hitherto unknown to them. Thus, the house of Fugger funded the colonial explorations of the kings of Spain and Portugal. Their agents even boarded the ships that arrived in Brazil, and went on from there to India.<sup>59</sup> The expansion of sovereign power and trade relationships went hand in hand. Major developments in the law facilitated these developments. Among them is the emergence of bills of exchange (even though legislation on bills of exchange dates from the 19<sup>th</sup> century).<sup>60</sup> They provided a relatively secure way of payment over long distances. No need to carry coins.

Let us move on to the Dutch and English colonization of the 17<sup>th</sup> and 18<sup>th</sup> centuries. In the initial phase, this expansion was driven by private actors such as the Dutch and British East India companies, rather than by sovereign-sponsored endeavors. These companies owed their capital to the “financial revolution”. This term designates the emergence of (domestic) capital markets in the Netherlands in the 16<sup>th</sup> century and in England in the 17<sup>th</sup> century.<sup>61</sup> The bonds of these companies, again an innovative legal instrument, were highly appreciated by tradesmen at the time. They provided compensation for the lack of currency. The supply of precious metals was not large enough to cater for the needs of an expanding capitalist economy. Fiat money did not exist as of yet; the sovereigns lacked the necessary trust. Therefore, merchants used bonds of the East India companies, particularly of the British one, like cash. They traded on large secondary markets at stable prices.<sup>62</sup>

Let me switch to another example, which represents a slightly different trajectory. Instead of financing the colonizers, surplus liquidity might finance the colonized and make them dependent via the debt. Germany’s colonial history offers lots of examples in this regard. First of all, Germany’s colonialism had almost purely economic motives.<sup>63</sup> In a period of domestic crisis in the 1885 and increasing tensions among European powers, the German government thought it had to secure access to resources and open new markets overseas in order to continue with its industrial expansion. In the establishment of German power, credit played an important role. German tradesmen provided overpriced goods to indigenous groups. The means of payment was credit. As many indigenous groups had limited access to finance and essentially worked in a non-monetary economy, they regularly could not repay their loans. The German tradesmen, and indirectly also the government,<sup>64</sup> accepted land instead of cash payment. In this way, land that used to be the communal property of a tribe was transformed into

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59 Klaus Weber, Geography, Early Modern Colonialism and Central Europe’s Atlantic Trade, 26 *European Review* (2018) 410, 412; see also Julia Roth, Sugar and slaves: The Augsburg Welser as conquerors of America and colonial foundational myths, 14 *Atlantic Studies* (2017) 436.

60 Legislation was adopted in France only in 1862, in Great Britain in 1882.

61 Peter Dickson *The Financial Revolution in England: A study in the development of public credit, 1688-1756* (Ashgate 1967); for the Netherlands, see Oscar Gelderblom and Joost Jonker, Completing a financial revolution: the finance of the Dutch East India trade and the rise of the Amsterdam capital market, 1595–1612, 64 *The journal of economic history* (2004) 641.

62 Gelderblom and Jonker (n 60).

63 Cf. Hans-Ulrich Wehler, *Bismarck und der Imperialismus* (Kiepenheuer & Witsch 1969).

64 E.g., the German government succeeded the rights of Lüderitz under the contracts he concluded with various indigenous captains.

farmland and, ultimately, German sovereign territory.<sup>65</sup>

Of course, finance was not the sole cause of colonialism during the imperial age. Ideology played a large role. Nationalism in Europe absorbed some of the energy released by unresolved class conflicts and projected them towards the outside. Also, internal divisions among African leaders made cooperation with European powers an option for some of them. Nevertheless, finance and the legal innovations supporting it, such as the introduction of a European, capitalist concept of property in non-European, non-capitalist societies, provided the background framework on which such developments could take place.

Even the independent states in Latin America fell victim to the colonizing power of finance. Their wars of independence and efforts at industrialization required large sums, provided mostly by capital owners in the United States and the United Kingdom in the form of bonded debt. Frequent crises, whether domestic or external, led to serial defaults. Nevertheless, the development of international arbitration and the ascendance of U.K. courts and later also U.S. courts to the peak of the worldwide judicial pyramid facilitated excessive debt bubbles. The judgments of these courts had a relatively high chance of compliance because of the importance of the respective financial markets, and not least because of the real threat of enforcement by gunboat diplomacy.<sup>66</sup>

The next example which I would like to discuss is the one that comes closest to the present situation. I am thinking about the debt crisis in the developing world taking place from the 1970s to the 1990s.<sup>67</sup> Again, it all began with the availability of excess liquidity – the so-called petrodollars. European banks found little use for this liquidity in their domestic markets. It was a period of high inflation combined with a protracted recession. The interest rate differential between the North and the South made capital exports attractive. In the recipient countries, investments went often into large infrastructural projects with relatively long amortization periods. Also, good governance was not yet a criterion for the allocation of funds. Some leaders took out loans in order to strengthen their legitimacy by the goods the money could buy.

When the US tightened the policy rate to curb inflation, the interest rate differential reversed. States in the Global South quickly faced difficulties to roll over their loans. To make a bad situation worse, commodity prices plummeted in the 1980s as a result of the transition to the service economy in the United States and other developed countries.<sup>68</sup> Deregulation in the 1990s led to further price drops, e.g. for coffee.<sup>69</sup> The result was a debt spiral, in which the exception became the normal and restructurings a routine.

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65 See in detail Matthias Goldmann, *The Entanglement of Sovereignty and Property in International Law: From German Southwest Africa to the Great Land Grab?* (October 28, 2018). Available at SSRN: <https://ssrn.com/abstract=3274198> or <http://dx.doi.org/10.2139/ssrn.3274198>.

66 See Horst Feldmann, *Internationale Umschuldungen im 19. und 20. Jahrhundert. Eine Analyse ihrer Ursachen, Techniken und Grundprinzipien* (Duncker & Humblot 1991).

67 Cf. External Debt Crisis and Development, Report of the Personal Representative of the Secretary-General on Debt, the Honourable Bettino Craxi, 8 October 1990, UN Doc. A/45/380.

68 Clifford Krauss, Commodity Prices Tumble, *New York Times*, 13 October 2008, <https://www.nytimes.com/2008/10/14/business/economy/14commodities.html>.

69 Passim.

Many legal developments made this misery possible. Above all the dependence of developing states on multilateral institutions in the hands of the capital-exporting countries. Before 1980, their task was mainly to enforce debt contracts. When there was still no end in sight of the crisis at the end of the 1980s, another legal innovation kicked in: securitization. Loans became Brady bonds, a convenient way for Western banks to remove the non-performing sovereign debt from their balance sheets. However, these bonds often did not stabilize the debt situation of the debtor states. They even increased the pressure and made restructurings more difficult as they multiplied the number of creditors.

My last example concerns foreign investment. Let me emphasize that I am not worried about foreign direct investment, i.e. the establishment of companies and production sites in the Global South. I have more doubts about portfolio investments, especially investments that come in the form of financial assets. They can have corrupting effect where supply, not demand for finance drives actual investments. Thus, foreign portfolio investment in Brazil only had the effect of reducing the domestic savings rate. In other words, instead of development, it created dependence on foreign finance.<sup>70</sup> Of course, international investment protection provided crucial support for the spread of foreign investment.

Before I conclude, let me be clear about one thing. This analysis of the corrupting power of an oversupply of finance does not remove individual agency or liability, civil or criminal, from those engaging in corrupt practices on both sides. To the contrary. Nor does it deny the influence of ideas and ideologies, of culture and eventually also of coincidence. But it explains a structural condition, an important feature of the background against which such individual acts of corruption take place. In other words, the oversupply money creates opportunities for corruption and dependency.

The lesson of this part is that economic and political self-determination require sustainable investments. Investments as such are neither good nor bad, they are double-edged swords, a blessing that can become a burden. To the extent that the supply of liquidity drives investments, rather than the demands of the economy, chances are high that the risks will outweigh the benefits, and bonds (in the sense of securities) will become bonds (in the sense of chains). Ultimately, it is the provision of liquidity itself which creates the potential for corruption.

## D. Solutions

By way of conclusion, let me offer a few thoughts on potential solutions. Four different recommendations come to my mind.

The first recommendation is economic. There needs to be regulation in place for the reduction of unhealthy supply levels of foreign capital. I am thinking about something like reverse capital controls. Normally, capital controls prevent capital from leaving the country. In case of protracted interest differentials, capital controls could help keep portfolio investments out of the country.

It is for economists to develop sophisticated models which would help determining unsustainable levels of capital imports. Of course, the imposition of such capital controls needs to be free from

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<sup>70</sup> Cf. Bresser Pereira, *Development and Crisis in Brazil, 1930-83* (1984), 32 et seq.

corruption. One might therefore be tempted to fight for a mechanical application of some economic model. However, I believe that this would only shift the point of contestation. There is no economic model which would not be based on certain political assumptions which are subject to interpretation. Therefore, I believe it would be better to establish a rather technical early-warning process on the basis of a sound economic model. This process would then trigger a transparent political process, in which the country would have to make a decision on the maximum amount of portfolio investments allowed during a certain period and their allocation. These allocations could use market mechanisms to reduce government intervention, such as competitive tenders, or taxes once a certain amount of portfolio investment has been reached.

This process, based in domestic law, would have to be secured by international investment law. Bilateral investment treaties would need an update to include exception clauses for the prevention of excess liquidity on the basis of sound, accepted early warning methodologies.

A second recommendation concerns the capital-exporting countries. They need to stop rebuilding their economies on cheap money. Such measures might be justified in the immediate aftermath of a crisis. In the long run, fiscal policy should be the means of choice, not monetary policy. Fiscal policy does not affect the monetary base and influences the interest rate only indirectly. The problem in capital-exporting countries at the moment are debt ceilings established over the last decades as part of a worldwide trend.<sup>71</sup> This prevents them from adopting more pro-active fiscal policies and forces them down the road of cheap money.

The third recommendation is institutional. Controls for portfolio investments and tighter monetary policy in the developed countries might reduce incentives for loan pressing and give less opportunity for corruption. However, corruption can always occur. No country is safe. Rules for transparency and due diligence might help, but only to the extent that there are independent prosecutors, courts, parliamentary committees, or ombudsmen, who are willing and able to enforce them. This might sound trivial, but it requires a lot of thinking to find ways how these institutions can be strengthened. For example, project financing, including credit guarantees, should require sustainability assessments, addressing their economic, social, and environmental impacts. The UNCTAD Principles on Responsible Sovereign Lending and Borrowing actually provide that such assessments should not only be carried out, but also be made public. A consistent practice of producing and publishing such assessments would make it easier for any observer to identify irregular transactions.

The fourth and last recommendation concerns the case when nothing works, i.e. when too much money entered the money unchecked, when sustainability assessments fail, and debt repudiation is impossible. In such a case, countries need an obligatory, international debt restructuring mechanism. The duty of states to progressively realize the economic, cultural, and social rights of their population requires international cooperation to solve debt crises. Certainly, the IMF, the World Bank, and the Paris Club have lots of experience with such situations. But it is difficult for them to restructure private debt at acceptable conditions. Any contractual mechanism for debt restructuring (such as so-

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<sup>71</sup> See Matthias Goldmann, *The Move towards Transparency in Fiscal Policy*, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2226879](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2226879).

called collective action clauses) has certain limits. Restructuring still require a majority of creditors, and creditors are (or believe they are) under no obligation to respect the public function of a state and its role for the implementation of human rights. A more effective mechanism is therefore desirable. The IMF itself came up with a proposal to this end in 2003.<sup>72</sup> However, it has not yet seen the light of the day. Such a mechanism should be in place before the next bubble of debt in the Global South bursts. As state above, chances are that it may burst soon.

This paper might therefore end with a rather bleak prospect. But the situation is not hopeless. And the bleakness of the current situation only corroborates my main message: Mozambique must not repay its odious debts.

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<sup>72</sup> Cf. Anne Krueger, A New Approach to Sovereign Debt Restructuring (IMF 2002).

# HOW TO AVOID THE REPETITION OF “ODIOUS” DEBTS?

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# 1. Africa debt context

A decade after global debt movements campaigned for debt cancellation many African countries are again in debt difficulties. African countries debt indicators are reaching thresholds that are not sustainable.

According to IMF list of Debt Sustainability Analysis 2018, shown in Figure 1 African countries in Debt Distress are eight (8), countries at High Risk of Debt Distress have reached 15, countries at Moderate Risk of Debt distress are 23, and countries considered to be at Low risk of Debt Distress number 8.

Out of the 23 African countries which are at high risk and in debt distress, almost half (12) have benefited from the HIPC and MDRI. African countries accumulated external debt at a faster pace than low-and middle-income countries in other regions, as shown in Figure2 below.

External debt stock of countries which benefited from the HIPC and MDRI have since doubled since 2010. Between 2010 and 2017, GNI in African countries in US\$ terms rose by 23 percent against a 90 percent increase in combined external debt stock during the same period.

Eight countries in the region had external debt to GNI ratio over 60 percent at the end of 2017, of which six of these countries benefited from the HIPC and MDRI. More than 50 percent of the region's countries had an external debt to export ratio over 50 percent.

**Figure 1:** Debt sustainability analysis in Africa 2018 – Assessing risks of debt distress (Source: Joint World Bank-IMF Low Income Countries Debt Sustainability Analysis 2018)

LOW RISK	MODERATE RISK	HIGH RISK	IN DEBT DISTRESS
	Algeria	Sierra Leone	Sudan
	Egypt	Angola	Sao Tome and Principe
	Mauritius	Namibia	Gambia
	Swaziland	Gabon	Mozambique
	Tunisia	Burundi	South Sudan
	Benin	Chad	Zimbabwe
	Burkina Faso	Cameroon	Somalia
	Comoros	Cape Verde	Eritrea
	DRC	CAR	
	Congo	Djibouti	
	Guinea	Ethiopia	
	Guinea-Bissau	Ghana	
	Ivory Coast	Mauritania	
	Kenya	Zambia	
	Liberia	Seychelles	
<b>Uganda</b>	Madagascar		
<b>Morocco</b>	Malawi		
<b>Libya</b>	Mali		
<b>Botswana Lesotho</b>	Niger		
<b>Rwanda</b>	Togo		
<b>Senegal</b>	Nigeria		
<b>Tanzania</b>	Equatorial Guinea		
	South Africa		

## 2. How To Hold Those Involved In Contracting Debts Accountable

Forensic audit - Attorney General's Office in 2018 to conducted a forensic audit. - audit helps for a judicial action by giving evidences and the judicial action can lead to reparations/prosectution.

Use of national laws and institutions - In 2016 and again in 2017, the Administrative Court (TA) ruled that guarantees and debts were illegal, violating both the Constitution and the budget law, which require such guarantees to be approved by parliament.

Use of parliament processes - On 30 November 2016, a special parliamentary committee took a similar decision stating that the debts were illegal and unconstitutional, noting also that the loans were largely for military purposes, that the limited amount of military equipment and equipment Privinvest were inadequate, the three companies would never be viable and could not repay the loans.



### 3. What can Mozambique do to avoid paying off debts, what mechanisms there are?- Recent examples of unilateral actions by States

**Paraguay** : In a decree of August 2005, the government of Paraguay has repudiated an illegal debt of USD 85 million owed to the Overland Trust Bank, based in Geneva. This political action is significant for two main reasons. First, it shows that public authorities have the right to determine a debt's illicit nature once the debt has been audited. And secondly, the decree demonstrates that a government's repudiation of a debt is a unilateral sovereign decision which must be accepted by the government's creditors if the repudiation has a legal basis. Paraguay has now the intention to put the case in the ICJ.

**Ecuador** : Rafael Correa took a decree the 5th July 2007 which creates the Commission of audit on public debt (external and internal). This is was unilateral act of a sovereign State. Audit is an important tool for democracy. It must be transparent and open to public. Thus, the Commission for the complete audit of domestic and external debt (CAIC) established by President Rafael Correa brought together delegates of State authorities as well as representatives of social and civic organisations in Ecuador and also delegates from North/South solidarity organisations who have demonstrated their expertise in issues concerning debt. Having carried out the debt audit, public authorities will be able to use both domestic and international law to repudiate all illegal and illegitimate debts.

**South Africa** : Mandela's post-apartheid government should have repudiated debts contracted by the criminal apartheid government instead of negotiating with creditors as it did under the pressure of external creditors. Indeed the UNCTAD report on the odious debt doctrine states that if South Africa had simply set up a ten year moratorium on the payment of debt accumulated by the apartheid regime, the government would have 'saved' USD 10 billion. Instead, it yielded to its creditors and paid the criminal debt of apartheid. As a counterpart it received a meagre USD 1.1 billion as foreign aid over the ten years that followed Mandela's election.

**Norway** : is a good example for States and social movements to follow. In October 2006, after a civil society campaign organised by citizens' rights movements, Norway accepted its responsibility in the illegitimate debts of 5 countries – Ecuador, Egypt, Jamaica, Peru and Sierra Leone – and decided unilaterally to cancel part of the debt due by these countries – to the tune of 62 million euros.

### 4. What can Mozambique do to avoid paying off debts, what mechanisms there are?

The Stolen Asset Recovery Initiative (StAR) supports efforts of policymakers and practitioners to return stolen assets, remove barriers to asset recovery, and prevent laundering of proceeds of corruption. StAR Asset Recovery Watch is a public database that tracks efforts by prosecution authorities

worldwide to go after assets that stem from corruption. The database compiles and systematizes information about completed and ongoing (active) corruption cases that involve international asset recovery. See a detailed guide to ARW [here](#).

United Kingdom and the United States supports the Stolen Asset Recovery Initiative (StAR). Currently the four priority countries are Nigeria, Sri Lanka, Tunisia and Ukraine.

Mozambique need to empower the investigators and prosecutors charged with identifying and tracing assets and getting necessary cooperation with financial centers in recovering and returning them - <https://star.worldbank.org/star/about-us/global-forum-asset-recovery-gfar>

## 5. How can civil society ensure a relevant role in this process and how can we avoid similar cases in the future?

Since the discovery of hidden debts, the Center for Public Integrity- Centro de Integridade Pública (CIP) has been engaged in promoting advocacy campaigns with citizens and public entities so that those involved are held accountable and the Mozambican state does not pay debts that have benefited a group of individuals.

It is important that African governments be adequately capacitated to effectively monitor and manage all aspects of sovereign debt.

This calls for adoption of appropriate legislation, strong institutions, prudent policies and strategies and adequate expertise, along with operationally sound systems and procedures that conform to best international practice.

Trainings, seminars and workshops on debt with MPs, CSOs, government officials and religious leaders.

Our advocacy on debt is guided by a human-rights based perspective on debt sustainability, responsible lending and borrowing to prevent debt crises, and work towards an international debt workout mechanism to resolve debt crises.

Transparency of debt information is important as it allows citizens to subject lending and borrowing to more scrutiny.

Private companies, governments and multilateral institutions are all significant lenders to governments, and so all need to take action to make lending more transparent. Information on loans to governments, or with a government guarantee, needs to be disclosed in one publicly accessible registry, within 30 days of contracts having been signed and include the value of the loan, fees, charges and interest, the law the debt is owed under, any available information on use of proceeds and the payment schedule.

# Hidden debts - a black swan that stung chicks?

## Challenges on fiscal risk management with subverted institutions

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# 1. Introduction

The terms of reference request me to talk about the following topics: 1) How to hold those involved (nationally and internationally) accountable for the (illegal) contracting of debts (and their concealment); 2) What can Mozambique do to avoid paying such (debts), what are the existing mechanisms; 3) What role can civil society play in this process of clarifying the process of contracting the “hidden” debts, holding those involved accountable, and following up on this case;

4) How can we avoid repeating similar cases in future.

This is not only a very broad agenda but it also involves the dimensions of specialties that I do not have to be ambitious to treat them with a minimum competence in a necessarily limited time intervention. So I will take refuge in my hiding place as an economist, and deal with aspects that seem closer to my field of knowledge and action. And for this I will make a proposition that I hope many will agree, which is: **the issues that were listed above can be considered risk management issues, and in this field we are more in the mitigation phase than in analysis and prevention.** To uncover this, just look at the keywords of each one of them (‘hold accountable’, ‘avoid paying’, ‘avoid repeating’), and take into account the notion of risk as the likelihood or threat of damages, or other occurrences of negative phenomena caused by external or internal shocks to an entity (person, family, organization, nation).

So, still with reference to the four proposed themes, I will structure my intervention on one point: **what is the nature (or type) of risk that the phenomenon of illegal and hidden debts in Mozambique represents?** From the understanding and answer that I find to this question, I will then go on to draw some lessons that can help answer the questions presented for our debate, especially the last question on how you can avoid repeating similar cases in future. Or rather, if given its nature, similar phenomena can be avoided.

Except Section 4 (structural measures) that was developed later, all topics covered in this document were presented and discussed.

## 2. Hidden and illegal debts as a special type of fiscal risk

### 2.1. Black Swan and the Birthday Piglet

I will introduce the substance of my intervention by clarifying the reasons for a part of its title: The Black Swan as an analytical concept in the modern theory of risk analysis and management<sup>73</sup>.

#### 2.1.1. Black Swan

Before the discovery of Australia, everyone in the world was convinced that all swans were white. Until someone somewhere in this “new world” saw a black swan among white swans.

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<sup>73</sup> The reference to chicks refers to the coded language that the perpetrators of the crime used in the exchange of messages referring to the millions of dollars that were distributed among enticers and enlisted in the scheme of the hidden and illegal debts, according to the revelations of the accusation of the American justice. See United States District Court, Eastern District of New York, Brooklyn Office, Indictment CR-681, December 2018.

Although the visualization of a white swan may have been a surprise not only to ordinary mortals, but even to the ornithologists at that time, but this is not the meaning of this story. What is most interesting in this whole story (as Taleb (2010) stresses) is how he demonstrates the severe limitations of our learning from observations, and the weaknesses of our knowledge. In this case it is seen how a single observation can invalidate a general affirmation or belief maintained over millennia of confirmatory views of millions of white swans. But then came the name of a phenomenon that does not necessarily have anything to do with birds (be they swans or chickens!). Black Swan is a key concept in modern theory and practice of risk management.

What in the modern theory and practice of risk management is called Black Swan (here I still help Taleb (2010) to capitalize the expression to distinguish it from Swan), is a phenomenon that has the following characteristics: 1) it is an event extremely outlier, an event out of regular expectations, because nothing in the past could point convincingly to the possibility of its occurrence; 2) it brings with it an extreme impact on the system it affects; 3) despite its characteristic as something outside normal expectations, after the facts human nature leads us to invent explanations of its occurrence, making it explicable. In short, an extremely rare phenomenon (not regularly expected), of extraordinary impact, and only “predictable” retrospectively (never really predictably prospective!) <sup>74</sup>.

As if this were not enough to cause us concern, we must add the fact that there is in us (both ordinary people and scientists - worse the practitioners of something like politics or governance!), the tendency to act as if Black Swans does not exist. We have an innate blindness<sup>75</sup> regarding the random nature of the events, particularly those that present themselves as great deviations from the expected regularity<sup>76</sup>.

Before elaborating the categories of risk and moving on to my discussion of hidden debts as a Black Swan, I will present another illustration of the phenomenon. This relates to how lucky I was on my piglet the day before my birthday. This will reveal another facet of the Black Swan, namely that it is only for the victims, but not for the perpetrators of the phenomenon. But still, it will reveal the mother of all problems in life, namely the question of whether it is logically possible for us from a specific event to reach general conclusions (which is what is implicitly in the fourth point of the agenda of this discussion). How do we know what we do not know? How do we know that what we have observed is enough to allow us to know all the other properties of the phenomenon that is about to affect our lives? There are indeed pitfalls in any knowledge built up from observations. Let's see.

## 2.1.2. My Birthday Piglet

Last September I turned sixty. A milestone that many of us tend to judge very important in our lives, and that is why we tend to celebrate it with a certain extravagance. Not that I wanted to display some of that extravagance (I've been building my housing and office since 2007 and I'm not done yet!), But anyway I thought I should celebrate the date with a certain decency. All the more so since I have grandchildren, and there is already a habit in the family to at least put out the candles, cut the cake and blow up a sparkling wine. But this time the financial situation did not allow this (having been “screaming” against hidden debts and other similar phenomena in our country, I have to accept to pay the consequences that the regime brings me).

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<sup>74</sup> It is observed by symmetry that the occurrence of a highly unlikely event corresponds to the non-occurrence of a highly probable event. So the fact that the highly expected event does not happen is also a Black Swan.

<sup>75</sup> One day we will speak about what we mean by innate but for now let me say that I mean those characteristics of ours that although they may have been genetically sown as fetuses evolved by conditioning the environment in which we live as soon as we leave them. Therefore, by innate I do not mean anything that is purely predetermined by nature and from there unchanging.

<sup>76</sup> Cyclone IDAI that hit the center and the North of Beira fits perfectly in the category of a Black Swan. And the innate blindness of politicians regarding the possibility that it might be an out-of-ordinary phenomenon was dramatically reflected in the President's decision to leave the country for a near-leap, under the circumstances, to the neighboring kingdom of Eswatini, exactly on the day the catastrophe struck over the country, despite weather forecasts indicating that the natural event would be extreme.

We met as family, my wife and I, and a seven-year-old boy. And it was this seven-year-old boy who came up with the cool idea of celebrating my sixtieth birthday with a well-roasted pig. Besides, we had a certain abundance of vegetables, although it was September, because when the idea of helping us in Tseke was spread by our creative Government, we already had the habit of keeping an hour “all year round” (as far as possible), and therefore this already and other vegetables exist in our portfolio of nutritional resilience.

The problem however is that this was the only pig we had. We gave up doing reproduction. We bought little piglets and we created “free range” (they stay there with the goats eating grasses and the remaining of our vegetable cabbages). It was a leftover of the three we had acquired a few months ago. His body did not develop for months. But when we ate the other two and he stood alone, making it almost that a pet began to gain a more pleasing appearance. Whenever we went to open the water tap for the goats, he would come running. All you had to do was listen to the snoring of the gate in the area where they lived in community with the goats on our property. Sometimes he did not show up, because he was always well fed and so he slept a lot. But we had even developed sounds of communication with him. We would emit these sounds, and he would wake up and come and go, get on our feet, fight with the kids to drink the water, then come and complain about the remaining cabbage in our garden, and almost eat from our hand. He developed well, all signs of rickets disappeared. It was very healthy and beautiful.

When the spectre of a sixtieth birthday without a penny to celebrate approached, and the idea of it being roasted at home came up as the solution, the second question was how to grab the pig. It's that despite being very close to us, he was always scared at the first sign of sudden movement. And the experience of grabbing the other two that had been eaten had been a little traumatic for me, that I'm not that young anymore. The decision was to develop an even more intimate relationship with him, bringing him more traces of cabbage and carrots from our vegetable garden. From time to time we would simulate little attacks but always followed by a good dose of food, until he was convinced that this was no more than a joke.

So it was easy on 4 September 2018 to complete the plan we had made. Early in the morning we picked the cabbages, opened the gate that leads to the animal husbandry on our estate, and made it with a little more clatter than usual. And he came running (the goats were still far away to eat the still moist grasses). We opened the water tap, threw the vegetables mixed with the water. I stood very close to the food container, and when he stuck his nose and delighted in his usual foods, zás! He was caught by his back legs. I hunted but it was not worth anything. Minutes later he had been beheaded and was being scalded. At 4pm the following day, my wife and I and the seven-year-old boy, together with two guests, sang the congratulations to me around a bowl with a suckling pig with vegetables.

Figure 1. illustrates the history of this piglet. What happened to this piglet on the 4<sup>th</sup> September, 261<sup>st</sup> day of its coexistence with us, was in fact dramatic. An extreme event, never before experienced by it. An event that completely changed its life - in fact he ceased to have life! (these are in fact the three main characteristics of a Black Swan). If it had survived (as it happened once to a goat that was grabbed and dropped because it was too small to be eaten), AND IF IT WAS A HUMAN BEING (!), Perhaps it had come to an explanation of the suffering to which it had been subjected (i.e. the reason why those damned humans would have tried to slice him!) - the other feature of the Black Swan (a posteriori explicability). But nothing in its life experience could have helped it predict the events of 261<sup>st</sup> (when he was seized and beheaded) and the next day (when the damned humans ate him to celebrate a poor life anniversary of one of them!) - Unpredictability.

Figure 1. 261<sup>st</sup> day in the life of a piglet



Note: Adaptation based on actual facts.

This story illustrates another feature of the Black Swan, namely the fact that this situation is for the victim. In the event where there is a perpetrator, he knows what he is preparing. The victim does not know. The surprise only exists for the victim. Extreme Impact also usually only exists for the victim.

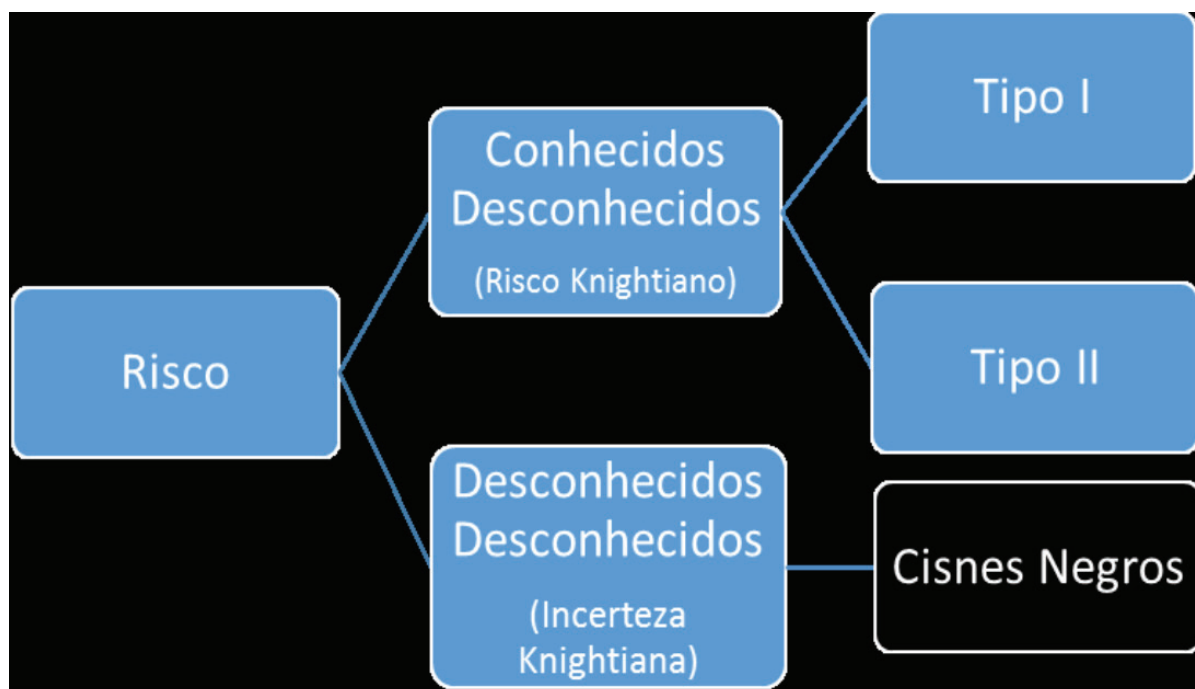
### 2.1.3 Risk classes

The scheme in Figure 2 organizes the various categories of risks. To understand this categorization we need to go deeper in understanding the concept of risk, in addition to what was said above. In particular, **we have to distinguish risk from uncertainty**. For this we could go to Leslie (1879), Haynes (1895), Ross (1896) or Pigou (1912). But Knight (1921) absorbed and synthesized the thinking of these all and gave us a definition of risk with a measurable nature. In the Knightian concept, risk applies to situations where “... *all alternative possibilities are known and the probability of occurrence of each can be strictly determined*”, while *uncertainty applies to situations where all possibilities are not predictable with no degree of confidence*. Thus, both risk and uncertainty are random phenomena, but while one (risk) can be described by a mathematical distribution, the other (uncertainty) cannot.

Modern science and practice in risk analysis and management inherited Knight’s distinction between risk and uncertainty, but he attributed to them the pedantic labels of “**unknown known**” (risk) and “**unknown unknown**” (uncertainty).



Figure 2. Risk Categories



Risks of the Unknown Known class fall into two types. Type I is characterized by Normal Mathematical distributions (Gaussian, ‘bell curve’), while Type II are Paretian (or ‘fat tails’) distribution.

One of the traditional and common ways of dealing with risk is to have insurance against this risk. Many of us do this. But the idea of insurance is based on the knowledge of a probability distribution of the event occurring. One of the sources of information for calculating the probabilities and costs of the event occur is the distribution parameters that characterize the risk in question. Normally, the parameters of the normal distributions are easier to calculate and are known to be stable over time, which facilitates their calculation and use in the calculation of risk insurance premiums. But the parameters of Paretian-type distributions are difficult to determine, meaning that the corresponding risks are more difficult to determine and predict, making your insurance more expensive.

In this essay I will study the “Unknown Unknown” (Black Swans). Thus, there are no known distributions. Therefore, there is no insurance. Insurance may deal with risk in the ordinary, traditional sense, which is not the case with uncertainty, or Knightian risk, for there is no known distribution. Thus, this risk is what is referred to as a Black Swan<sup>77</sup>.

## 2.3 Hidden Illegal Debts as Black Swan

I may venture here to answer the fourth issue of the agenda, which asks, “How can you **avoid repeating similar cases [to hidden and illegal debts]** in the future?” My answer is that similar cases (in the sense of Knightian risk of Black Swan type, or the birthday piglet) cannot be prevented (anticipated or avoided). Nothing can be done to avoid something whose possible existence is unknown. *The type of risk that the phenomenon of hidden debts poses generally cannot be avoided because it is a type of risk whose existence is not known before it materializes.* Let’s see in part.

**Firstly, the unpredictability factor.** The scheme of illegal and hidden debts involved the violation of the Constitution of the Republic of Mozambique. No ordinary-minded Mozambican could expect

<sup>77</sup> For an extensive discussion with historical and contemporary examples see Végh, Carlos A. et al (2018), in addition to Taleb (2010).

that the President of the Republic who swore to be the guardian of the Constitution of the Republic, could himself make the decision to consciously violate it and in as serious a manner as he did. In that act sovereignty bodies were severely subverted. What happened was an act of great disgrace of the Mozambican nation, promoted by someone whose ideology (if that became ideology) preached the self-esteem of the Mozambicans. Discovering the illegal debts, and the way the government later tried (and still tries) to cover them up and protect their perpetrators, makes Mozambicans today seen as a lot of mistrust around the world, objects of derision, all from afar something that can promote self-esteem<sup>78</sup>. It is one of the biggest scandals of corruption, promoted by agents of the regime to the highest level at the time when they proclaimed by every corner the “fight against corruption”. And as for the creditors, it distinguishes the originators whose agents also operated fraudulently, those investors who were deceived by fallacious prospects of the EMATUM notes.

Let us remember that all this happens in the wake of Mozambique having signed an agreement with the International Monetary Fund that would imply for the first time in more than ten years that the country would return to a program with IMF financing. Prior to this, Mozambique was in a “Policy Support Instrument” regime, where the IMF appears to advise on policies, monitor, provide technical assistance and issue “certificates of good standing” (such letters of comfort that donors and investors need), but without lending any money to the country. And it was precisely in the golden age of foreign investment, stimulated by the discovery of large reserves of gas and minerals, and by “good macroeconomic policies.” Let us remember that it was exactly in May 2014 that the IMF came down in weight to Maputo for a conference to proclaim ‘Rising Africa’, an event marked dramatically by a picture seen by the World putting the IMF General Director side by side with then President of the Republic and his Minister of Economy and Finance. Far from it, knowing that while they were taking this picture with her, behind her back they were scheming the debts they concealed from the Mozambicans and the organization she directed. And that is precisely why the program is signed in December 2015 and then cancelled in March / April 2016 when hidden debts were publicly reported.

Therefore, the element of surprise, of almost total unpredictability of the hidden debts is clearly apparent.

The second element that characterizes the hidden debts as a Black Swan is its extreme impact on the economy and life of Mozambican people. This impact is still felt four years later. It is the responsibility of the various sectors to analyse the impacts in the different spheres of socio-economic and institutional life of the country. A quick look at the very aggregate economic variables shows how in fact the shock caused by this crisis was profound. The scandal erupts in 2016, causing a cut in IMF financial assistance and direct support from foreign donors to the budget. The rating agencies dramatically downgrade the country. The Mozambican debt securities in the international markets devalue massively, with their interest rates surpassing in one day those of Venezuela that at the time were considered the worst among all countries (Figure 2). Foreign direct investment falls dramatically. The metical exchange rate deteriorates. The financial system entered into a crisis of confidence and restricted the supply of credit, companies suffered from the shortage and the increase in investment.

The cumulative effect is reflected in the Gross Domestic Product, which declined in such a way that in 2016 it was at the same level as in 2005 (twelve years decline in a year). This is extraordinary and has never happened before since the end of the civil war in 1992. The political tones of the crisis are also unprecedented. Indeed, for the first time in recent history, the level of GDP in the third year of a President’s first term of office was below the level at which he arrived in the office, revealing his incapacity in dealing with the crisis that was first reflected in denial of the existence of illegal and hidden debts, and then a refusal to initiate an effective fiscal adjustment as public accounts deteriorated.

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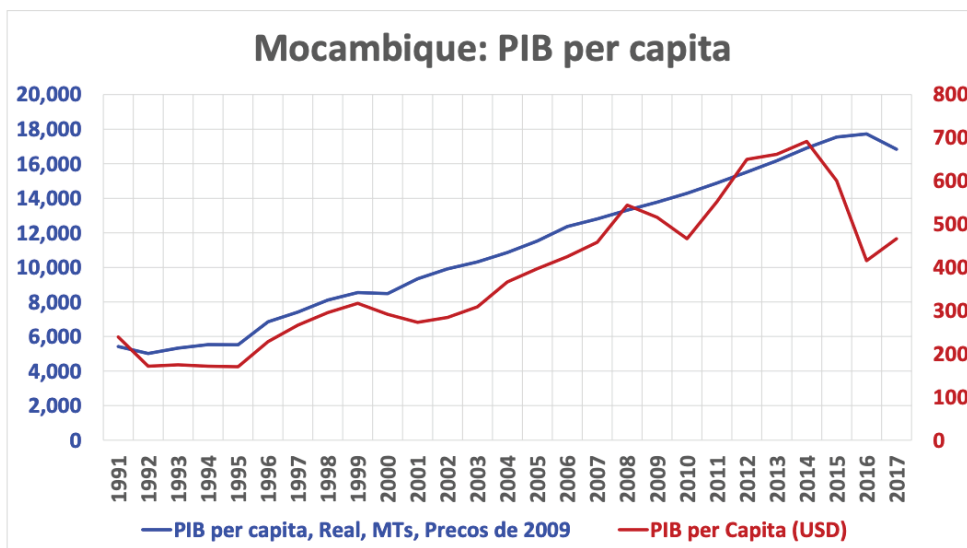
<sup>78</sup> Even in times of national disaster as in the current cyclone IDAI case, the world looks suspiciously at the government and does not recognize it as a reliable entity to be the channel of aid to the Mozambican people, making rescue and assistance operations even more difficult for the affected populations.

**Figure 3.** Collapse of the Eurobond title price of Mozambique in October 2016

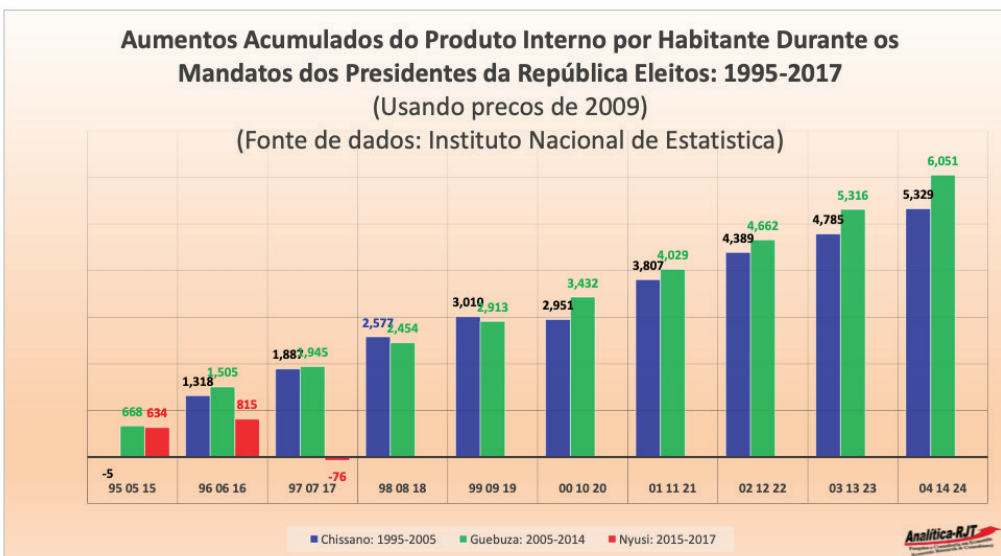
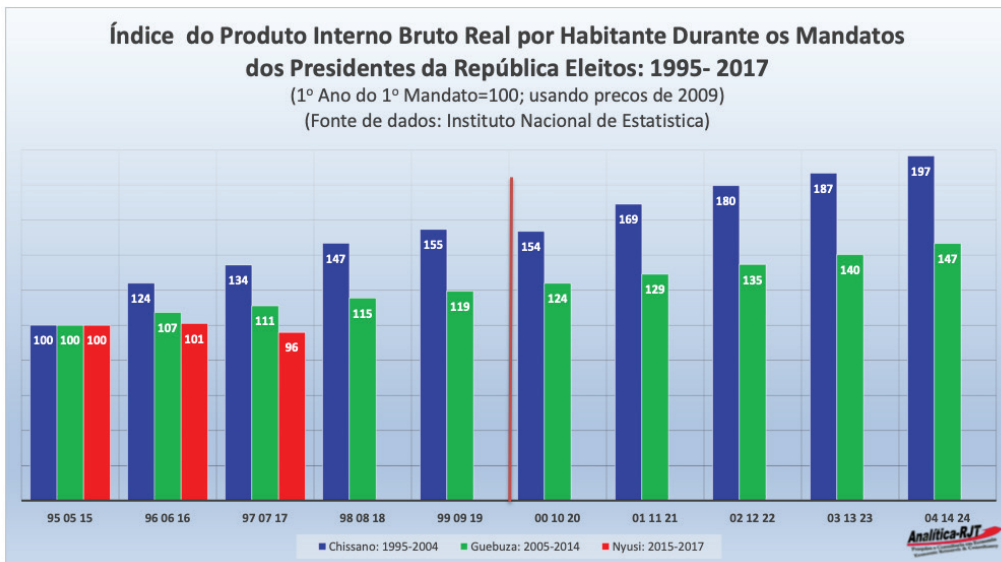


Source: <https://www.bloomberg.com/news/articles/2016-11-10/hedge-funds-line-up-against-mozambique-in-battle-over-tuna-bonds>

**Note:** In October 2016 the government announces the restructuring of EMATUM notes, creating the titles ‘Eurobond Mozambique 2023’. The jump in the rediscount rate (reflected in the price collapse) of Mozambican debt followed exceeded one day the Venezuelan Eurobond rate which at the time was considered the worst of all the countries in the world. In January 2017 the international investment bank JPMorgan announces (fact that was consummated) that the Mozambican government will not be able to pay the coupon of the new title. There followed a further price collapse to record levels (the title is quoted at almost half its original price).



- Between 2016 and 2017, per capita GDP declined to a level of ten years before being triggered by the crisis caused by hidden debts;
- For the first time in recent history the level of GDP in the third year of a President’s first term of office was below the level at which he took office.



Source: Author’s calculations using INE data

As a **third element**, human nature impels to seek an explanation a posteriori of the phenomenon of hidden debts. I am not referring here to the fallacious justifications of the authors on the reasons that led them to make such decisions (i.e., defence of the national economic zone and natural resource projects, not to disclose the defence strategy to the enemy-RENAMO). I am referring to analysts’ attempts to explain why everything happened, what factors were behind (i.e., weakness of the public finance management system; the greedy / ambitious nature of Mr Armando Guebuza, then President of the Republic (such as the usual “Ah ... Samora said that this man was too ambitious to be trusted ...”) and his close associates. Interesting fact is that these factors (ambition, institutional weaknesses) are not discovered after the hidden debts. They were already mentioned even before the phenomenon. But when it is verified, they are sought to constitute explanatory factors of it. That is, they were not predictive factors but serve as an explanation later. In human nature the White Swan finds a predictability a posteriori.

## 3. A roadmap for mitigating the effects

All that has been said above suggests that the question of how one can avoid repeating similar cases in future has no place in the context of Black Swans, because these are risks whose existence one cannot even want to be known about. You cannot prevent what you do not know and whose probability of happening is also unknown.

But this does not mean that there is nothing to do to deal with this type of risk. Once the risk has materialized, society can and should take the necessary lessons and measures to minimize their effects. This relates to the remaining three items on the agenda.

In terms of risk management theory and practice we would say that with this kind of risk that the only instrument available is the mitigation of the consequences. And that's what the other three agenda items are about. To a large extent the questions put forward are essentially legal, a matter on which I am not competent and so I will not say extensively but mention aspects of principle that reflect my convictions on the problem, not doctrinal aspects.

### 3.1. Should we pay or not the hidden debts, or how to be compensated?

For the Mozambican people who pay taxes and who were not involved in hiring these debts, this was settled long ago. Although justice has yet to play its role, there is sufficient evidence that it was a fraudulent exercise perpetrated by domestic and foreign individuals associated in their private benefit with a view to laying the burden on the Mozambican people. No money should go out of the Treasury to pay fraudulently contracted debts for the private benefit of individuals (nationals and foreigners) involved, and no national wealth should be pledged for that purpose.

However, the Government has a responsibility to organize an orderly resolution of this problem so that Mozambique as a state reinserts itself in the concert of nations and returns to international markets with the credibility it needs. This requires the Government to take steps to hold the national individuals involved accountable and to repair the damage caused to the Mozambican people and the foreign investors who have been genuinely circumvented.

In other words, for Mozambican workers and taxpayers the issue is not only not to pay, but rather how to be compensated for the damages caused.

#### 3.1. 1 Criminal responsibility

There was never any doubt that in contracting the debts of EMATUM, Proindicus and MAM, and in issuing the respective guarantees, there was a violation of the law, in an act involving the President of the Republic and his close collaborators (Minister of Finance, Director of State Security and Information Services, among other senior government officers).

The nation would come out of this imbroglio extremely uneducated if a violation of the law, in particular of the Constitution of the Republic, for whom it had the obligation to defend and enforce, not only be unpunished, but not even condemned by the appropriate judicial forum.

The arrests and accusations recently filed by the Attorney General's Office are too late (about three years after sufficient evidence has come to light) and they are apparently the result of an effort to

avoid even more serious revelations that would result from possible extradition of the former Finance Minister who was detained in South Africa in December 2018 at the request of the authorities of the United States of America requesting his extradition to this country. In fact, the crimes of which the former ruler is accused of in the United States of America violate the Law of that country in the framework of their captivating motives to investors and money laundering gained in connection with his role in contracting the hidden and illegal debts. It is thus to be expected that within the framework of this prosecution and trial the elements (which have already begun to come out) will involve other Mozambican agents involved in the embezzlement of more than US \$ 2.0 billion through EMATUM, Proindicus and MAM.

Despite its seemingly cosmetic and manipulative character (in the effort to bring the former Finance Minister back to Mozambique and thus avoid the possible disclosure of these implicating elements), it is essential that justice entities move forward with prosecution, trial and conviction of those involved in the fair measure of their criminal acts.

### **3.1.2 Seizure of the convicted criminals' property**

The assets of those who are proven to be implicated and guilty must be seized, liquidated and used to solve the problem of these debts. Given the particular nature of this problem, new legal and administrative instruments may be required to address this issue. It will be necessary for the financial resources gathered with this confiscation and liquidation to be used solely and exclusively for the resolution of all the problems created by the scandal of hidden and illegal debts, including: a) compensation of the Mozambican government; b) compensation of the society in general; and the compensation of the genuinely embezzled investors.

## **3.2. The Government's Responsibilities and Role**

The government is responsible for solving the problem of hidden debts for both creditors and Mozambican society. The government must ensure that the national taxpayer does not pay these debts, that national wealth is not pledged to irresponsible and deprived creditors, and that the Mozambican society and the state are, as far as possible, reimbursed for the damages caused by this imbroglio. The assets of those involved which will be seized by order of justice institutions must be applied for these purposes.

To this end, the Government should:

- 1) Establish an Independent Committee to solve the Debts problem of Proindicus, EMATUM (CIRD-PEM), a Committee which will be responsible for: i) Determining the losses to the Mozambican Treasury derived from the hidden debt scandal, such as the amounts of foreign aid lost since the scandal broke, the interest paid (secretly or not) since the debts were contracted; restructuring costs incurred by the government, the costs of legal and financial advisory services contracted by the government to deal with hidden debts until the time of establishment of this Committee, and all other charges borne by the government closely linked to the hidden debts; ii) Determining the costs / losses to Mozambican society to which a fair value can be associated by which society can be reimbursed through direct allocations to communities or social and economic programs (such as the potential losses of Gross Domestic Product over the years of the crisis caused by the hidden debt scandal)

Organize a **Conference with Creditors and Donors for the Resolution of the Crisis Proindicus, EMATUM (ConfIRDD-PEM) debt** in which the government presents a resolution plan guided by the following principles:

- a. The Mozambican government will not pay the debts of Proindicus, EMATUM (CIRD-PEM) because they are illegitimate and illegal and they did not benefit the Mozambican people because they were fraudulently originated by employees of foreign entities in collusion with Mozambican government officers acting in default of the Law and for private benefit.
- b. The Mozambican government takes the responsibility for facilitating the resolution of the problem of reimbursing of the national treasury, the Mozambican people and investors genuinely deceived through (i) the sharing of all information collected by the national justice system during investigations and prosecution of the national concerned; returning to an “Investors’ Club” the remaining value of the assets seized from the involved nationals, once deducted the costs to the treasury and reimbursed the Mozambican company for the estimated fair value of the damages caused;
- c. It is up to the Investors (including originators and secondary purchasers of debts) to find the mechanism of allocation between them of the value received, liabilities for the losses caused to each other (originators and secondary purchasers) and other measures they deem necessary to be held accountable and compensated by others involved who fall outside the jurisdiction of the Mozambican authorities.

To ensure transparency and as an expression of the Government’s genuine willingness to participate in solving this problem, the following must be observed:

- a) The Evaluation, Settlement and Debt Resolution Committee should be made up of international and national members, such as representatives of creditors, donors, Government, and Mozambican Civil Society;
- b) The studies and evaluations of the Committee must be entrusted to companies and / or technicians contracted in open international tender;
- c) The government must submit to the Parliament a motion for a resolution that declares illegal and void to the Mozambican State the debts and guarantees issued in connection with the operations of Proindicus, EMATUM and MAM, and approval of the above-mentioned resolution roadmap, with deadlines, in particular for the establishment of the two Committees and for the holding of the Conference of Creditors and Donors.

## 4. Structural measures with immediate, medium and long-term extent

In order to learn the lessons from the experience of various types of fiscal crises and their resolution, several countries have developed two institutional mechanisms that have proven to be of great value in strengthening public finance management systems. These are the Laws of Fiscal Responsibility, and the Independent Fiscal Councils<sup>79</sup>. Although the experience of this type of institution has initially occurred in developed countries, it now spreads beyond them, if not in form, at least in some of the basic functions<sup>80</sup>.

Due to the requirements that the establishment of these institutions bring in terms of complementary capacities, there has been a certain reluctance to promote their establishment in developing countries. For example, it is argued that transparent monitoring of the implementation of some provisions of a Fiscal Responsibility Law requires a very strong and transparent national statistical service, free of manipulation, credible for all parties involved (Executive, Parliament, Civil Society, and other international partners). However, these services are lacking in environments in less developed countries such as Mozambique, and this is often used as an argument to point out the impossibility of a Fiscal Responsibility Law in this context.

In the case of the Independent Fiscal Council, resistance to its establishment in environments such as Mozambique is justified by the supposed lack of technicians with knowledge and experience of public finance management who are both politically exempt and credible so that their analyses, evaluations and opinions are accepted by the society as a whole and by political groups in particular those represented in Parliament.

My experience and knowledge of what is happening in many African countries (including in Mozambique) is that these arguments, although with a certain amount of reality, are largely fallacious. This is not the place to develop my counterargument, but suffice it to note the following: with regard to the supply of statistical services and products, demand may force both quantity and quality to increase. And as for the scarcity of politically exempt and capable technicians, my observation is that in most cases it is the government (the executive branches!) that rejects and ostracizes the most technically capable and politically exempt national citizens. Many African nationals shine abroad (both assisting or working for governments and working for international organizations), while at the same time in their countries they are excluded and / or considered incapable by their governments, often pushing them out of the country looking for their professional valuation and survival and material and financial security.

It concludes that the establishment of modern and robust public finance management institutions in countries such as Mozambique is not a question of technical feasibility or scarcity of staff, but rather of political will of governments (Executive and its parliaments). This willingness, of the institutions that I suggest below, can be established, developed and it is very useful for the strengthening of public finance management in Mozambique. The report of the Parliamentary Inquiry Commission on hidden and illegal debts has many recommendations of legal aspects that must be improved to strengthen the management of public finances. It should constitute a raw material to be improved and incorporated into the Fiscal Responsibility Law and the attributions of the Independent Fiscal Council of Mozambique.

<sup>79</sup> Among others, see Baetsma, Debrun and Kinda (2014), Roe, et al (2018), International Monetary Fund (2013), and Lienert (2015).

<sup>80</sup> For example, Chile does not have an Independent Fiscal Council, but it has three independent committees or groups of experts: The Advisory Committee for the GDP of the MoF (ACTG), The Advisory Committee for the Reference Copper Price of the MOF (ACRCP), and the Advisory Committee of the Ministry of Finance. For more details on the accountability and fiscal transparency institutions in Chile, see Schmidt-Hebbel (2012), which is based on the Chilean Fiscal Responsibility Law. In Brazil, the former President was dismissed based on legal arguments pointing to breach of the law. In South Africa the Parliamentary Budget office has some of the typical functions of the Independent Tax Councils, as well as in Kenya which has some of the most robust experiences in Africa in this area. Still incipient yet promising experience is also developing in Uganda.



## 4.1. Fiscal Responsibility Law

With regard to the Fiscal Responsibility Law, the World Bank and the International Monetary Fund are fortunately already convinced and in their Joint Recommendations for an Action Plan submitted to the Government in March 2018 (Annex III to the Report on Article IV Consultations of 2017) include the following as an action to be taken in the theme of Governance, with a date of implementation until the end of 2018:

*“Submit to the Parliament a proposal for a Fiscal Responsibility Law.*

*The main purpose of the law proposal should be: (a) to maintain fiscal stability and ensure debt sustainability; (b) to ensure fiscal transparency; (c) to establish future-oriented and performance-based financial management; and (d) to ensure accountability of the government to Parliament. The law proposal should be anchored in a medium-term sustainable debt strategy, and frame the creation of a Sovereign Wealth Fund (FRS) and fiscal rules to ensure the efficient management of natural resources. To ensure effective implementation of the Sovereign Wealth Fund, the Regulations of the law shall be adopted six months after its approval. “(P. 43).*

I would also add to this recommendation the establishment of an Independent **Supervisory Board** by specific Law and Regulation, as will be summarized below. This is another institution about which I have been speaking for some time but about which there is still some reticence for some individuals. I believe that an Independent Supervisory Board would be an extremely useful aid to monitor compliance with the Supervisory Responsibility Law and other legislation and principles of responsible and transparent management of public finances.

## 4.2. Independent Supervisory Board of Mozambique

The ISBM must have at least one of the following mandates:

- 1) **Evaluate the government’s annual and multi-year macro fiscal projections**, including their comparison with alternative projections prepared by the Board itself and / or other entities (i.e those prepared by IMF, World Bank, Economist Intelligence Unit, Banks, Universities, and offices or groups of local studies and economic projections, among others),
- 2) **Evaluate the position and fiscal results of the government**, including the monitoring and evaluation of projections of the medium-term fiscal and budgetary framework with respect to the rules, targets and limits of the fiscal balance and public debt, and to make the necessary recommendations for the correction of deviations.
- 3) **Carry out or evaluate the costing of new initiatives of policies or measures of both expenditure and revenue**, or proposals of policies or manifests of political parties, or the costs of legislative initiatives;
- 4) **Specific studies** to improve the performance of certain operations of public entities.

To succeed in these tasks the ISBM would have to:

- i) have a mandate derived from a broad political consensus resulting from an agreement between all the major political parties at the time of their establishment;
- ii) enjoy credibility based on political independence and the ability to respond to requests for studies and opinions;
- iii) To have a clear mandate of its obligations and prerogatives established by Law;
- iv) Independence and non-partisanship, including independence of political influence;

- a leadership selected on the basis of its technical competence and distancing from political engagement, chosen by consensus of several political parties and endorsed by Parliament, with proven competence in economics, and analysis and management of public finances;
- v) enjoy independence of operational and financial management;
  - vi) have unrestricted access to information on the economy and public finances in particular, and any restriction due to confidentiality and national security is only that established by law;
  - vii) Be provided with a governance structure clearly defined in the law establishing the entity;
  - viii) adhere to strict observance of standards and rules of conflicts of interest;
  - ix) be provided with resources allocated through the State budget, subject to similar allocation and management rules to other independent agencies with a multi-year perspective;
  - x) maintain transparent relations with the media;
  - xi) be subject to accountability, including the linkage of its products with the budget cycle so as to support Parliament in its analysis and deliberations on the annual budget, as well as the obligation to make statements to specialized parliamentary committees whenever that called to such;
  - xii) be subject to an independent evaluation of CFIM's assets and products by a panel of independent experts with international composition, conducted periodically;
  - xiii) All of this based on a legal framework brought to parliament by the government and approved by consensus, and a Memorandum of Understanding practice to establish channels and formal procedures for communication and exchange of information with the main government entities with which ISBM would have to collaborate in order to strictly comply with its mandate (i.e. Ministry of Economy and Finance, Administrative Court, Central Bank, Tax Authority, Secretariat of the Assembly of the Republic, large public companies, among others).

## 5. Conclusions

The phenomenon of illegal and hidden debts that brought Mozambique into a sudden economic and financial crisis of extraordinary proportions presents the existence of a special type of risk whose prevention is impossible because it has never happened, neither known nor expected in the country. But once it has happened, robust mitigation measures have the potential to create an environment that can discourage its repetition. Such measures involve the criminal accountability of the perpetrators and the compensation of those harmed.

The government is responsible for resolving the imbroglio of hidden and illegal debts. These responsibilities extend to restoring the state's reputation before the international arena and the citizens. However, national taxpayers should in no way be prejudiced. On the contrary, one of the responsibilities of the government is to ensure the compensation, by the perpetrators of the crime that is proven judicially, not only of the creditors who may have been effectively embezzled, but of the Mozambicans in the first place. Seizure of the assets of the perpetrators according to the established judicial mechanisms must be followed by their orderly liquidation and application of the results in the compensation of the public treasury and the embezzled companies, and only the remaining amount must be handed over to the creditors organized in order to distribute among themselves possible compensation. This is different from making the national taxpayer pay the hidden and illegal debts. This must be the meaning of the expression "I do not pay the hidden and illegal debts" that must be complemented by the expression "I demand reimbursement".

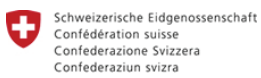
The proposed roadmap for resolution of the imbroglio includes the creation of liquidation of seized assets and settlement of debts with broad participation of all stakeholders: Government, Creditors, Donors, Civil Society, and Parliament, and it should be such that have the appropriate legal framework and support for specific Parliament resolutions. What is proposed here is completely different from a restructuring in the traditional sense (renegotiation of deadlines, interest rates, hair-cuts, etc.). The government must clearly state that it does not pay odious and ill-owed debts but it assumes the responsibility of collaborating and doing its part to make it easier for the perpetrators to repay the impaired parties, including the National Treasury and the Mozambican society in general.

In addition to the proposed measures for orderly resolution of the debt imbalance, public financial management and control institutions need to be strengthened. The adoption of a Social Responsibility Law within the scope proposed by the World Bank and the International Monetary Fund and the establishment of an Independent Supervisory Board as proposed in this document would be two complementary measures that would help to materialize the recommendations of the Independent Parliamentary Commission of Inquiry, and would make robust the Parliament independent monitoring of public finance management in Mozambique.

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