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Odette Lienau

Cornell Law School, ol53@cornell.edu

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EXTENDING THE EUROPEAN DEBT DISCUSSION TO BROADER INTERNATIONAL GOVERNANCE

By Odette Lienau *

Although Europe is no stranger to sovereign debt troubles, the focus of international debt governance for several decades has been on the developing world. Discussions surrounding the efficacy and appropriateness of crisis mechanisms have been shaped by this political reality. But the current focus on Europe itself may generate changes in how public and private actors view international debt governance and the legitimacy of crisis mechanisms. In these remarks, I will focus on two ways in which Europe might serve as a test case for broader governance practices. First, I will discuss the ramifications of the European Union's potential adoption of new debt restructuring institutions for debates that emerged in the developing country context. Second, I will address what the European situation suggests about state sovereignty in the international economic realm, considering both sovereignty's external and internal dimensions.

RAMIFICATIONS OF A EUROPEAN APPROACH FOR DEVELOPING-COUNTRY CONCERNS

The European debt crisis is a significant problem for developing countries simply by virtue of Europe accounting for roughly twenty percent of the world economy. Many of these states are at least partially dependent on European export markets, with closely linked economic fates. That said, the developing country relationship with Europe is not entirely one of export dependence. Indeed, the situation in Europe throws into fresh relief the shifting balance of world financial power. For example, although European leaders remain deeply critical of China's resistance to revaluing the yuan, they very much welcomed Chinese Premier Wen Jiabao's reassurances in October 2010 that China would continue to invest in Euros.¹ This greater equalization of financial capacity over the last ten years has enabled major emerging economies to play a new financial role.

Nonetheless, the international debt regime has been directed toward developing countries for several decades. This regime has been organized to a significant degree by institutions and creditors in the developed world, and has exhibited a distinct North-South dynamic at certain points. As such, any European mechanism will be unique in terms of both its more integrated political context and the relative uniformity of its country participants.² Any compromises or new institutional frameworks established under these circumstances could be considered an incubator for farther-reaching mechanisms in international economic governance.

As background, there are two general approaches to thinking about debt restructuring. The first is a private contractual approach centered on mechanisms like the use of collective

* Assistant Professor of Law, Cornell University Law School. I would like to thank the ASIL Annual Meeting Committee and Whitney Debevoise for organizing this panel. For a broader discussion of certain themes in these remarks, see ODETTE LIENAU, *RETHINKING SOVEREIGN DEBT: THE POLITICS OF REPUTATION IN THE TWENTIETH CENTURY* (forthcoming 2012).

¹ Maria Petrakis & Natalie Weeks, *China Supports Stable Euro, Won't Reduce European Bondholdings*, *Wen Says*, BLOOMBERG (Oct. 3, 2010), available at <http://www.bloomberg.com/news/2010-10-01/china-s-wen-visits-greece-to-sign-cooperation-deals-show-confidence-in-eu.html>.

² For a leading European restructuring proposal, see François Gianviti et al., *A European Mechanism for Sovereign Debt Restructuring: A Proposal* (2010), <http://www.bruegel.org/publications/publication-detail/publication/446-a-european-mechanism-for-sovereign-debt-crisis-resolution-a-proposal/>.

action clauses (CACs) in bond issues. These clauses provide that, in the event of a default, a restructuring of payment or other terms approved by a supermajority of bondholders will be binding on all. This approach can help to address coordination problems and avoid the threat of aggressive litigation by holdouts, which can diminish funds available for other creditors and derail the restructuring process as a whole. An aggregation clause inserted across a range of bond issues takes this a step further by providing that creditors across different bond series may all be bound by a restructuring agreement. Notwithstanding the minimal coordination problems at issue in the European arena—and the already widespread use of CACs—the European Union has mandated that such clauses be part of all Eurozone bond issues from July 2013.³

The second “statutory” approach to restructuring involves a more formal institutional framework, something akin to a domestic bankruptcy proceeding. The best known of these proposals is the Sovereign Debt Restructuring Mechanism (SDRM) initially endorsed by Anne Krueger of the International Monetary Fund in 2001.⁴ Adopting an SDRM-type framework has the possibility of bringing all creditors together for a general workout, regardless of the type of creditor or the form of debt. This could more thoroughly deal with underlying insolvency issues and moral hazard problems and so put countries’ economies—and the global financial system—on a stronger foundation. Such an approach would likely include a stay on litigation, mechanisms for granting seniority to new financing, and provisions for binding minority creditors. An SDRM-type structure could also be expanded to bring a country’s foreign and domestic creditors into the same restructuring framework. Although the necessity and efficacy of a European SDRM remains heavily contested, any such institution is more likely to be successfully adopted in a setting such as the European Union, where supranational governance structures connected to domestic courts and agencies are already in place.

How might European decisions on these mechanisms be interpreted at a global level, especially by developing countries that have borne the brunt of debt restructurings over the last several decades? To begin with, speaking of a “developing country” perspective on sovereign debt or on the establishment of formal restructuring frameworks is something of an oversimplification. In earlier discussions about a possible SDRM in which the IMF might play a major role, developing countries split on several issues. Some objected to the conflict of interest inherent in having a major creditor—with already considerable coercive power—also act as a potential arbiter in any bankruptcy-type proceeding. Several were concerned that creditors would interpret the very existence of a formal SDRM as making restructuring easier and therefore more likely. Borrowing could become more difficult and expensive, compensating for the risk of an SDRM-based restructuring. Brazil and Mexico, seemingly after discussions with their private creditors, expressed such concerns and ultimately opposed the proposals.⁵

Others, of course, remained convinced that a more orderly mechanism was necessary. A degree of restructuring is likely, given the vagaries of borrowing in external markets, in foreign currencies, with externally determined benchmark interest rates, while simultaneously

³ For concerns about the efficacy of CACs, particularly in the European context, see, e.g., Anna Gelpern & G. Mitu Gulati, *Forward: Of Lawyers, Leaders and Returning Riddles in Sovereign Debt*, 73 *LAW & CONTEMP. PROBS.* i, ii–xiii (2010).

⁴ Anne Krueger’s initial November 2001 speech, “International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring,” is available at <http://www.imf.org/external/np/speeches/2001/112601.HTM>.

⁵ For brief overviews of issues surrounding the IMF SDRM proposals, see, e.g., Eric Helleiner, *Filling a Hole in Global Financial Governance? The Politics of Regulating Sovereign Debt Restructuring*, in *THE POLITICS OF GLOBAL REGULATION* 89, 100–20 (Walter Mattli & Ngaire Woods eds., 2009); Gianviti et al., *supra* note 2, at 15–19.

relying on export markets for significant foreign capital. Furthermore, many countries do not have the clout of Brazil or Mexico, and so cannot bring creditors and benefactors to the table to arrange rescue packages or ad hoc restructurings as easily. Less systemically important borrowers could be left in limbo in the absence of a clearer mechanism.

While Europe certainly exhibits a center-periphery dynamic, no country in the Eurozone can be ignored for too long without threatening the whole. As such, Europe displays both more internal pressure and more developed political foundations for a deeper institutionalization of debt restructuring. Any steps taken by Europe will be watched closely by those concerned with broader global governance, and may be understood as a test case for more extensive reform. As such, what lessons might come from a European context? First, the development of a European SDRM could formally establish the precedent, commonplace in the domestic arena, that creditors bear some of the burden when the financial picture turns bleak. This expectation is already tacitly present in debt restructurings, but has emerged as a real issue in Europe. European—and particularly German—taxpayers resent paying for bailouts that they believe should be at least partially funded by private creditors taking a loss. Second, the European situation could be an important test for whether there is a real backlash from creditors, for example, in terms of higher borrowing costs.⁶ Finally, if Europe took the initial step toward greater institutionalization of debt restructuring, it might ease the concerns of major emerging powers by relieving them of responsibility for the first formal SDRM establishment or the mandatory use of CACs. A European normalization of either approach would likely ease the way for their adoption on a global scale.

EXTENDING QUESTIONS OF SOVEREIGNTY FROM THE EUROPEAN CONTEXT

The second broad question I would like to address is what sovereignty means in the context of sovereign debt crisis management, and how the European milieu sheds new light on this discussion. As a conceptual matter, sovereignty can be understood in two ways. First, the external dimension of sovereignty focuses on the state as a unitary actor with exclusive control in its own territory vis à vis external parties. Second, the internal idea of sovereignty can be conceived of as the legitimating relationship between a ruling government and its population.⁷ The European setting touches upon both of these elements in ways that are relevant for broader questions of international economic governance.

The external vision of sovereignty—if it ever existed in practice—has been chipped away by a range of forces: powerful private actors engaged in semi-regulatory behavior, intergovernmental networks less bound to domestic power bases, and supranational public actors making policy decisions previously reserved for states. However, particularly in the context of debt restructuring, this diminution of state sovereignty has not been evenly spread. For example, stringent and arguably domestically invasive loan conditions became much more common during the developing country debt crises of the 1980s and the 1990s.⁸

The recent bailout packages for Greece and Ireland—and now potentially Portugal—have brought the conditionality discussion out of the developing country arena. The fairly standard

⁶ As an empirical matter it might be difficult to tease out this particular effect. *But cf.* Barry Eichengreen & Ashoka Mody, *Do Collective Action Clauses Raise Borrowing Costs?*, 114 *ECON. J.* 247–64 (2004) (suggesting that CACs lower borrowing costs for creditworthy borrowers, but can raise them for those considered more risky).

⁷ For a slightly different characterization of this internal and external dimension, see, e.g., Robert H. Jackson, *Sovereignty and World Politics: A Glance at the Historical and Conceptual Landscape*, in *SOVEREIGNTY AT THE MILLENNIUM 11* (Robert H. Jackson ed., 1999).

⁸ The earlier, post-World War II lending by international financial institutions to European countries had been more accepting of domestic policy control.

conditions attached to these European packages, which do infringe on areas traditionally associated with domestic sovereignty, have been incredibly unpopular. Finding such measures difficult to implement, Greece has fallen behind on several economic restructuring targets set last spring, and the possibility of default remains on the horizon. Ireland is pressing for lower interest rates on loans it received in the fall of 2010, but continues to resist any additional conditions. And in Portugal, there is significant public opposition to additional austerity measures, notwithstanding the risk that the conditions attached to any European Union and International Monetary Fund bailout would likely prove even more stringent.

While at points last year there was speculation that the Eurozone could collapse back into monetary sovereignty, this eventuality seems improbable now. A second potential outcome would be to move in the opposite direction by combining the already existing monetary unity with greater fiscal policy coordination. Despite indications of willingness on the part of some European leaders, this deeper fiscal integration runs afoul of voter sentiments in many Eurozone countries. More likely scenarios include either the public fully acceding to austerity measures or a compromise being reached to protect certain social safety nets. Developing countries, the historical focus of loan conditionalities, should attend to the final outcome. If the European public establishes a floor of minimum social spending, they can reasonably ask whether such a floor should transfer elsewhere or moderate the initial conditions proposed. If, on the other hand, European publics ultimately accept stringent cuts, this may narrow the space for arguments against conditionality and also for framing any criticism of the practice as a North-South issue.

The second or internal aspect of sovereignty as a legitimating relationship between a government and its population has not been at the forefront of European discussions. However, certain background rhetoric still touches upon this element—for example, by suggesting that in democracies such as Greece, Ireland, and Portugal, the populations supported government actions related to debt and should therefore bear the burden of adjustment. This attention to democratic legitimacy and responsibility falls in line with broader trends in international relations. In the context of the “Arab democratic spring” there has been discussion of how democracy is emerging as an international right—and how the repression of internal populations should have financial consequences. In the Libyan context, U.S. Treasury officials stated that in freezing Libya’s assets they sent a “powerful message to anyone that holds government power that if you engage in the kind of brutal repression that we’ve seen in Libya in the last several days that the US will do everything in its power to find and block assets.”⁹

The longer-term question remains as to how far the linkage of financial responsibility with democratic accountability will go. If part of the logic for Greek austerity measures lies in its population’s indirect authorization of the debt, what does this mean for countries that were not democracies when their debt was incurred? Should the populations of Algeria, Egypt, and Libya be subject to the same austerity measures, even though they had no say in (and arguably little benefit from) the initial loans? Similar questions could be raised by countries that have shouldered debt burdens contracted by dictators who fell before the most recent wave of democratization. These intimations at least discursively open the way for greater consideration of an odious debt doctrine. Any such conversation would likely be welcomed by a range of developing countries, but strenuously opposed by creditors.

⁹ Robert O’Harrow Jr. et al., *U.S. Found a Surprise as It Sought to Hinder Libya*, WASH. POST, Mar. 24, 2011, at A11.

CONCLUSION

Although today the world's focus is on Europe, sovereign debt problems will remain a feature of global financial relations for some time. Given that much of the contemporary international debt architecture emerged through developing country crises, Europe's current situation may well alter the debates going forward. I suggest that two discussions are particularly noteworthy for developing countries. First, any EU adoption of new debt restructuring institutions—for example, a formalized restructuring mechanism—may serve as a test case for changes in broader global governance, including by assessing long-run creditor reactions. Second, the eventual European response to austerity measures infringing upon domestic sovereignty could shift the global discussion surrounding the appropriateness of loan conditionalities. Relatedly, focusing on democratic accountability for debt raises questions about whether the absence of democratic control in other regions should result in reduced payment obligations. Given the continent's distinctive political and economic integration, these ideas or trends would be unlikely to transfer seamlessly. However, any future changes in global debt governance are likely to respond to prior developments in Europe.