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Sovereign Debt Restructuring, Refinancing and the Financial Market

A Comment on Lienau's 'Rethinking Sovereign Debt'

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Abstract: Lienau's book on 'Rethinking Sovereign Debt' delves into international finance to shed light on its background rules, overarching ideologies and interacting actors, disentangling the social norm of sovereign debt continuity and its institutional foundations. What a formalistic legal reasoning would interpret as a self-contained bilateral contract is then situated in historical time and social space populated by a variety of actors (debtors and creditors), co-existing legal regimes and evolving principles of reference. Her focus on odious debt highlights situations where debt continuity is challenged by major events in the sovereign borrower status (such as major political regime change, corruption and human rights abuse) which challenge debt legitimacy. This comment expands on her thoughtful analysis by linking debt continuity to the borrowing sovereign entity as a going concern. Sovereign borrowing makes lenders involved with this ongoing entity through time and circumstances. Ongoing sovereign debt management is featured by both debt securities market trading and the refinancing mechanism. In turn, refinancing involves public finances with their public benefit missions, central banking and the monetary base management. In this context, socially responsible lending and borrowing may be facilitated by acknowledging the bonding relationship between the borrowing sovereign entity and its creditors, including when default occurs.

Keywords: sovereign debt, public debt management, sovereign debt restructuring, fiscal consolidation, international financial law

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Disentangling the never-ending story of the social norm of debt continuity

Lienau’s (2014) book develops a thoughtful and well-documented work on what we may call the institutional foundations of international finance. “There is a necessary and mutually constitutive interaction between actors and broader institutions and norms – between agents and structures – that affect how interests are formed and understood” (2014, p.16), she claims. Her analysis delves into international finance to shed light on its background rules, overarching ideologies and interacting actors, disentangling the social norm of debt continuity with its historical roots and its evolving frame of reference.¹ The evolving state of this social norm is then embedded in the institutional regime (s) of sovereign debt, that is, the set(s) of “implicit or explicit principles, norms, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations” (Krasner 1983, p. 2).

Accordingly, the currently taken-for-granted interpretation of this norm assumes that “sovereign borrowers must repay, regardless of the circumstances of the initial debt contract, the actual use of loan proceeds, or the exigencies of any potential default” (Lienau 2014, p. 1). Lienau shows historical examples that illustrate how this norm has been factually reshaped and framed in some situations, providing an historical overview of its situated evolution in contexts featured by a variety of rules, principles, and actors. In this way, her analysis

¹ International finance of sovereign debt comprises two cases: a sovereign borrowing position denominated in domestic currency and held by foreign lenders; and a sovereign borrowing position denominated in foreign currency. This comment is especially concerned with the first case.

sheds light on the non-market sphere that accompanies, complements, and somehow embeds the financial market sphere where this norm is allegedly expected to be rooted. The sovereign borrowing-and-lending transaction is then understood as a financial transaction embedded in institutions that frame and shape it through time and circumstances. Accordingly, what might appear as a self-contained bilateral contract is situated in historical time and social space populated by a variety of actors (debtors and creditors, financial advisors, legal counsellors and scholars, policy-makers, international organisations), co-existing legal regimes, and evolving principles of reference. In this context, Lienau does argue for an interdisciplinary approach combining (international) law with (international) politics and (international) economics, in view to better address this socio-economic scene of sovereign debt (international) financing.

From an institutional economic perspective, Lienau's analysis highlights a fundamental matter of coordination which the institutional structure(s) of international finance appears to deal with. This coordination occurs in various phases, namely: (i) at issuance (when the borrowing position is being to be taken); (ii) throughout the outstanding phase, when the position is held and serviced; and (iii) in a challenged and possibly defaulted situation, when the position is questioned and eventually restructured or repudiated.

Lienau's focus on odious debt devotes special attention to the issuance phase. Regarding debt continuity, she considers its legitimacy, pointing to historical cases where a new government established after a major political regime contested obligations taken under the former regime, or where loan proceeds were appropriated for private benefit purposes (as opposed to public benefit purposes on behalf of the people). Considering the lending structure, she stresses the coordination among creditors which was generated by the World Bank action and by syndicated loans. This coordination has upheld that peculiar interpretation of the social norm of debt continuity, whereas competition between creditors during the issuance phase may and did occasionally undermine that interpretation (making it dependent on the eagerness of new potential lenders to replace incumbent creditors which still hold contested debt claims).

Lienau's historical account of sovereign debt financing parallels the recent emergence of financialisation and related development of international capital markets, which were put at the core of international finance architecture since the disband of the Bretton Woods Accord (Biondi 2016a; Lienau 2014, Chapter 5). Accordingly, sovereign debt lending appears to have progressively moved into the sphere of international capital markets since the nineties, through the triggering sovereign debt crises of late 1970s and 1980s (Lienau 2014, Chapter 6). At that time, the sovereign debt restructuring (SDR) "plan proposed by US Treasury Secretary Nicholas Brady to significantly restructure the lingering debt, centered

on an exchange of bank debt for tradable bonds, helped to revitalise sovereign debt markets” (Lienau 2014, p. 193).

According to World Bank and IMF (2014, Section 6) ‘Revised Guidelines for Public Debt Management, sovereign “debt managers should take adequate measures to develop an efficient government securities market”. “To the extent possible, [sovereign] debt issuance should use market-based mechanisms, including competitive auctions and syndications”, while “governments and central banks should promote the development of resilient secondary markets that can function effectively under a wide range of market conditions.”

Lienau’s (2014) focus on odious debt brings her attention to situations which link debt continuity to changes in the sovereign borrower status (such as major political regime change, corruption and human rights abuse) which challenge its legitimacy. But her main argument is not so much concerned with debt continuity in itself, as with its peculiar interpretation through a ‘statist theory of sovereignty’ that frames understanding of sovereign borrower continuity (2014, p. 3). Her analysis shows how alternative views have existed, still co-exist, and may then be jointly or alternatively endorsed to frame and shape the social norm of debt continuity in ways that permit selected repudiation in some circumstances. Indeed, her argument concerns the situated understanding of debt continuity in the eyes of actors and rulers. As a matter of fact, from a functional viewpoint, continuity points to the borrower’s ongoing operations that have to be continued. As a going concern, the borrowing sovereign entity cannot be liquidated. As for this ongoing entity subsumes the financial and economic process through which sovereign states perform public benefit missions on behalf of the people, including the monetary base management. Creditors cannot take control over these institutional functions and sovereign economic policy. Sovereign states are then ‘by definition’ a going concern, while sovereign entity representation makes that process traceable and its decision-makers accountable over time and circumstances. Continuity constitutes the condition that enables the very possibility of sovereign debt restructuring, including in ways that permit debt forbearance or repudiation. This focus on the borrowing entity as a going concern invites us to consider the outstanding phase of public debt management – when the debt is held and serviced – and its institutional structure.

International financial markets and the borrowing sovereign entity as a going concern

From this perspective, sovereignty does not seem to be the only conceptual conundrum to be addressed in the received understanding of debt continuity as

a legal, political and moral must. In a context featured by financialisation and the mantra of international capital markets, this taken-for-granted view on debt continuity may be fostered by a formalistic legal understanding of the sovereign debt contract, coupled with a simplistic alignment with private debt under contract law. This formalistic understanding goes along with the myth of *the* financial market investor that has been resonating in the institutional scene over recent decades (CONVIVIAM 2013). According to this understanding, a lender is an investor which enters a sovereign debt position by acquiring a debt instrument, generally a security which is freely transferable and traded on regulated security Exchanges. Security trading enables both liquidity through continuous trading, and ongoing valuation through ever-changing market prices generated through that trading. In turn, continuous trading holds on the implicit assurance of security on its terms and conditions. The rule of law may then be expected to protect investors in case of default, enforcing this security. Consequently, market 'liquidity' may be claimed when arguing for 'debt continuity' and 'debt security'. Borrower's assurance of security through continuity enacts its access to liquid security markets for sovereign debt issuance.

As a matter of fact, liquidity does not prevent solvency issues that may occur (Biondi & Fantacci 2012). Insolvent borrowers can and have defaulted on some debt obligations through time and circumstances, including sovereign debt securities that were traded. Actually, market traders are expected to include some valuation of borrower default risk in their pricing assessment, including through specialised transactions such as Credit Default Swaps (CDS). In this context, tradeable securities are one possible legal form of the relationship between a sovereign borrower and its creditors, along with loans and credit derivatives. The default situation does abruptly confront market investors with the non-market dimension of sovereign debt lending, including by making sovereign securities *illiquid*, that is, not smoothly transferable without huge losses through market transactions. Indeed investors are remembered to have acquired, held and traded securities that have been issued to fund a sovereign borrower and his ongoing financing needs. Although the security is generally designed to remain quite independent from the counterparty's situation, it is still a legal form for a bonding financial relationship with the sovereign counterparty.

Since a mutual relationship was established through the debt contract at issuance and during its outstanding phase, can lending investors be excused from considering their counterparty's situation when default occurs? Lienau's historical investigations on odious debt situations shows how lenders were somehow involved with - and were then legally challenged on the basis of - the actual use of the loan proceeds and the borrower's political agency. Both conditions seem to be especially concerned with the issuance phase, when

lenders are expected to perform their due diligence on borrowing counterparties. Nevertheless, further involvement occurs throughout the outstanding phase of sovereign debt lending (Biondi & Boisseau-Sierra 2016).

Generally speaking, a featured institutional structure is in place during the outstanding phase, in view to back and facilitate sovereign debt financing, assuring debt market liquidity through a dedicated set of non-market institutions. In this context, as long as sovereign debt securities float on market trading, sovereign issuers keep rolling them over at market conditions; that is, when one debt issuance comes to be repaid, a new one is issued to refinance the former. From the viewpoint of individual holders, sovereign debt is normally to be remunerated by interest charges and repaid by capital installments at its nominal value; however, at the aggregate level, these borrowed funds are spent, transferring them across constituencies for public benefit purposes through public policies (Biondi 2016b). This debt-spending mechanism is made possible by continued refinancing of debt positions at every capital installment, which makes sovereign debt an essentially monetary phenomenon (Perroux 1949, p. 96–97). This regular refinancing of government debt makes the debt stock indefinitely outstanding (and also growing, in absolute terms and more or less in parallel with nominal GDP).

This refinancing mechanism is backed and facilitated by central banking and the monetary base management. It is generally accepted that central banking assures liquidity of governmental debt (Andolfatto, Li & others 2013; Bell 2001; Ize 2006; De Grauwe & Ji 2013). Open market operations and other monetary policies operated through central banking do monetize governmental debt, at least temporarily (Beard et McMillin 1986, Salsman 2012, Buiter 2007, Mishkin 2009). Singh and Stella (2012) include into “money-like assets” both central bank deposits (reserves) and every collateral that can be converted into central bank deposits generally at par, such as governmental debt securities. Moreover, whenever central banks do issue *ex nihilo* paper money (legal tender), they generally buy back governmental debt securities against this creation. In this context, accounting consolidation of central banks within central government accounts clears all doubts concerning sterilization of governmental debt held by the central bank itself, for both interest charges and capital repayments (Biondi 2015 for the UK case).

Sovereign debt market trading is embedded in this non-market institutional framework. According to Standard and Poor (2013, p. 35), the proximity between the state and the central bank facilitates financial sustainability and then improves the credit worthiness score, in comparison with states submitted to monetary unions. In this context, markets for sovereign debt have been organized to assure the quasi-monetary dimension of this debt, accompanying and reinforcing its interdependence with monetary policies coordinated by central banks under regime of fiat

money and bank money creation (McLeay, Amar & Thomas, 2014a, 2014b). Under this regulatory architecture, the monetary base has been endogenously created by central banking in interaction with monetary financial institutions, in a way that does accommodate issuance and refinancing of sovereign debt over time.

In sum, sovereign debt refinancing mechanism points to the unique connection between sovereign debt and the monetary base, since refinancing transforms sovereign debt in quasi-money through time. Public debt management is then connected with public-spending (so-called fiscal policies) and monetary policies. When (foreign) investors acquire sovereign debt, they play a role in this socio-economic scene which enacts their financial position through refinancing, central banking and the monetary base management. This ongoing involvement with the borrower and its financial structure applies when market investors trade on sovereign debt instruments through time. Arguably, this same involvement may be claimed when default occurs.

Throughout debt issuance and outstanding phases, a mutual relationship between sovereign borrower and its creditors is established and maintained. Lenders' capacity and willingness to lend to the sovereign debt issuer depend on lenders' uses of that debt, as well as on the borrower's capacity to sustain it over time, that is, the borrower's capacity (and willingness) to fulfil debt obligations when they are due in time and amount. As a matter of fact, both capacities relate to the refinancing mechanism: Lenders were aware of refinancing policies (and needs) by treasuries, while benefitting from refinancing provided by central banking and the monetary base management. On the one hand, refinancing makes sovereign debt lending related to public finances and their public benefit purposes. On the other hand, refinancing makes sovereign debt markets related to and dependent on the non-market dimension of monetary base management. This implies that lenders have been functionally involved in the borrower's situation by investing in and trading on sovereign securities. Arguably, they may then be required to attend to this situation, including when default occurs. This duty of care may involve acting in a socially responsible way in case of borrower's default.

Current trends for and against socially responsible lending and borrowing

Consequently, may this social responsibility of lending be acknowledged and enforced, in view to reshape the social norm of debt continuity? Lienau (2014, Chapter 7) shows that this norm is currently submitted to quite opposite trends.

Concerning trends against socially responsible lending, some foreign investors have claimed a formalistic interpretation of sovereign debt contracts before international tribunals and US courts. Concerning international tribunals (Lienau 2014, p.203; Ishikawa 2014), the ICSID case *Abaclat vs. Argentina* upholds a legal argument which blurs the line between sovereign bonds and direct foreign investment,² affording the risk to overprotect foreign lenders' claims, which would be then insulated from the regular lending regime based upon refinancing. In this way, foreign lenders could profit from the latter regime without contributing to its coordinated rescue in case of sovereign debt restructuring (SDR). Concerning US courts (Ishikawa 2014), vulture funds' legal actions appear to draw upon a formalistic legal argument on sovereign debt obligations.³ If enforced, this argument would disrupt collective restructuring procedures that are applied to cope with sovereign debt crises (Lienau 2014, p.207). Again, opportunistic foreign investors may then free ride on the cost of restructuring at the expense of other debt-holders, breaching the Paris Club principle of comparable treatment.

This opportunistic behaviour in case of default shows the dark side of competition among creditors. Fair solutions may then emerge less from undermining coordination among creditors, than from reshaping the ways in which this coordination is enacted and enforced on the institutional scene of sovereign debt markets. Concerning trends favouring socially responsible lending, the United Nations Conference for Trade and Development (UNCTAD) finalised its Principles on Promoting Responsible Sovereign Lending and Borrowing in January 2012. According to article 7 of the UNCTAD Principles, "a creditor that acquires a debt instrument of a sovereign in financial distress with the intent of forcing a preferential settlement of the claim outside of a consensual process is acting abusively". Moreover, loan contracts do increasingly include provisions such as collective action clauses (CAC), aggregation clauses, and exit consents (Lienau 2014, pp. 198–199 and

² The problem with *Abaclat v. Argentina* (and *Ambiente v. Argentina*, *Alemmani v. Argentina*) is that the sovereign debt at issue was sovereign bonds traded in secondary market, held by multiple individual bondholders, with no connection with specific investment projects in the host state. By contrast, a promissory note issued by the host state to finance a specific project of building highways, for example, may well qualify as an 'investment' protected by international investment treaties. The blurred line between the two kinds of debt was stressed by Prof. Abi Saab in his dissenting opinion. Theoretically speaking, this interpretation does further point to the distinction between productive (real) and financial (monetary) investments and related financing. Alvarez (2011) expressed further concerns on corporations as subjects of international law.

³ Concerning a similar case before UK courts, see Lienau (2014, p.201). On the Greece's settlement case with vulture funds, see Dearden (2012).

207). References to CAC were introduced in the revised Guidelines for Public Debt Management issued by IMF and World Bank in March 2014 (IMF 2014).⁴

Our analysis has highlighted the link between sovereign debt, fiscal policy and the monetary base management. The need to maintain (and restore) well-functioning monetary system and public service gives an additional reason to consider the imperative of adequate and timely resolution of sovereign default, in which case opportunistic investors who undermine a collective restructuration are to be deemed ‘abusive’.

In conclusion, the social norm of debt continuity keeps being reshaped and reframed in historical time and social space, as it has always been the case. From this evolutionary perspective, a formalistic interpretation of debt continuity may favour irresponsible lending and borrowing behaviours, while an acknowledgement of borrower continuity as a going concern – that is, its need to maintain and restore refinancing mechanisms that are fundamental to public finances and the monetary base management – may facilitate responsible sovereign borrowing and lending, including in international finance.

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⁴ To be sure, these clauses enable collective action over – and then coordination of – holders of the same debt issuance, while a sovereign default would generally involve holders of different debt issuances. The clauses address then the coordination within one debt transaction, while leaving coordination between debt transactions unaddressed.

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