Crisis Talk at Humboldt University

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Isabel Feichtner Di 17 Jan 2012

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It's easier to talk about love than about the debt crisis. Talking about the debt crisis, however, can be lovely. The conference "A Debt Restructuring Mechanism for European Sovereigns. Do We Need A Legal Procedure?" at Humboldt University on January 13 and 14 was a demonstration of lovely crisis conversation.

Christoph Paulus, Professor of Private Law at Humboldt University, had convened a group of economists and lawyers, academics and practitioners from Europe, the USA, Latin America and Japan to discuss causes and responses to the European debt crisis. Even though the emphasis of the conference lay on Europe, and more specifically a formal restructuring mechanism for sovereign debt in Europe, voices from outside enriched the debate, presenting legal approaches to the indebtedness of states and municipalities in the United States and Japan.

Listening to the presentations and debates was in several ways reassuring. Not only was the tone and atmosphere so cordial and friendly, the discussions also conveyed the impression of broad consensus among the presenters as to the feasibility and desirability of legal procedures for an orderly debt restructuring.

Some of the participants are directly involved in the ongoing crisis management. Among them Ludger Schuknecht, economist at the Ministry of Finance, who stood in for Finance Minister Wolfgang Schäuble. His speech did not surprise – the essence being: We are on the right track – dealing with the current crisis as well as preventing and addressing future crises. He stressed the importance of avoiding a disorderly default and the need for a more rule-based governance – the latter to be achieved through the European Stability Mechanism and reforms to the Stability

and Growth Pact's preventive and corrective arms, including the new fiscal compact. His optimism also extended to the ongoing negotiations on private sector involvement (i.e. the voluntary taking of losses by private investors) in the handling of the Greek crisis which were likely to be concluded successfully (on Friday evening successful conclusion still was not in sight). The crisis countries themselves had to address the root causes of the crisis by reducing public debt and budget deficits and increasing their competitiveness. This required structural reforms including spending cuts and flexibilizing labour markets. With respect to the narrower conference topic, Schuknecht pointed to the decision of the European Council of 26 March 2011 to include collective action clauses in all new euro area government securities from July 2013.

Being Poor as a Good Thing?

A number of people in the audience, myself included, wished the speaker would concretize the recent intentions of Merkel and Sarkozy to address unemployment, explain how the small steps towards financial regulation taken so far would restore the primacy of politics over the financial markets. Instead he emphasized the importance of restoring market confidence and praised the virtues of being poor. Sometimes, he responded to a question by the Irish ambassador, it is better to have little money since little money tends to be spent more efficiently.

Michael Burda, Professor of Economics at Humboldt University, subsequently set out to explain the economic causes of the crisis. He too did not go much beyond the diagnosis of over-borrowing and otherwise unsustainable fiscal policies. He did not use the opportunity to critically evaluate the official German position favoring austerity, for example by addressing fundamental challenges faced by European economies including how to ensure competitiveness of service-oriented economies vis-à-vis economies based on manufacturing and – more generally – how to address trade imbalances.

Mario Blejer, Governor of the Central Bank of Argentina during Argentina's debt crisis, took a more critical stance, especially regarding Germany's opposition to the European Central Bank acting as a lender of last resort. Since this matter had caused some confusion among lawyers I was particularly grateful for his clarification on how to think about IMF lending in the European debt crisis. While countries – when insolvent – may have to default on foreign debt, local debt (debt denominated in domestic currency) can always be paid and default never happens. The country merely needs to enhance the supply of its currency. The situation is different in the euro area where the European Central Bank determines monetary policy, including money supply. If the European Central Bank refuses to act as a lender of last resort, countries like Greece or Italy or Spain, in the words of Bleier, become like Panama in that they do not have a domestic currency. Even debt denominated in Euro for them is foreign debt.

The IMF borrows from Europe to lend to Europe

To pay this debt the IMF now is lending Euros to European countries whose currency is the Euro (but which for them amounts to a foreign currency). In short: the IMF borrows from Europe to lend to Europe. To Blejer this does not make sense. Instead, the ECB should directly intervene as a lender of last resort and provide money to governments. It should not only, as it currently does, provide indirect support through buying government bonds on the secondary market or providing unlimited credit to banks. By now we all know the rationale for involving the IMF: "Moral Hazard". The detour via the IMF, Blejer fears, will damage its credibility; not only because it would not be needed if the ECB intervened (currently such intervention would violate EU law), but also because its acting as a lender to Europe will lead to double standards. It is not to be expected that the IMF enforces conditionality as strictly vis-à-vis European countries as it does towards developing countries.

All three presentations were fodder for controversial debate. However, the audience (of academics, practitioners and civil servants) seemed quite content to take it all in (throughout the conference only one "Wutbürger" vented his anger at the endless need to "pay, pay, pay") and move to less disputed (really?) territory, namely the actual workings of sovereign debt restructuring in situations of insolvency and the desirability of a formal legal procedure to

facilitate and legitimize such restructuring.

On this point there seemed to be much real consensus – the economist Jeromin Zettelmeyer from the European Bank for Reconstruction and Development being slightly more skeptical about the need for a formal legal procedure than his lawyer colleagues. A formal restructuring mechanism (along the lines of the Sovereign Debt Restructuring Mechanism negotiated within the IMF at the beginning of the millennium until negotiations failed in 2004) could facilitate an orderly default with negotiated haircuts by overcoming collective action problems, most importantly the problem of hold-outs (which collective action clauses can only go so far in addressing). (I will spare you the details on the pros and cons, many explanations on this topic can be found on the website of the International Insolvency Institute).

What Is Won With A Legal Procedure?

A formal legal procedure for sovereign insolvency (or "resolvency" as Paulus would have it) could legitimate sovereign debt restructuring by providing for non-discrimination among creditors, making restructuring more transparent and inclusive and thus potentially more democratic. The latter point was stressed by Mathias Audit, Professor of Law at Université de Paris Ouest Nanterre La Défense). Not too surprisingly, it was the scholars from the United States who critically questioned enthusiasm for a formal legal procedure. Thus, Anna Gelpern, Professor of Law at American University, stressed that more was needed to make responses to sovereign default fairer or more democratic. Law, as we should know, can also work the other way, by entrenching interest and power constellations. She also pointed out that state banktruptcy in the United States (which currently is not a legal option) was associated with right-wing politics seeking to weaken labour unions. Michael Waibel (Lecturer of International Law at Cambridge) with his fascinating account of the Financial Commission of Control instituted in the 19th century by European powers to administer Greece's insolvency also wished to caution against over-optimism in legal engineering.

The presentations and questions from the audience touched upon two specific issues which indeed may seriously complicate things and impede the adoption of a formal restructuring mechanism that enhances legitimate debt restructuring. One is the impact of financial instruments such as Credit Default Swaps (insurances against sovereign default) on the restructuring of sovereign debt. Another (related one) is the impact of the finance industry's lobbying on the political process.

Opinions on how Sovereign Default Swaps affect debt restructuring processes diverged. Ernst-Moritz Lipp, former chairman of the London Club and thus highly experienced with the restructuring of sovereign debt owed to private creditors, stressed the contribution of derivatives to fundamental changes in financial markets, their increased intransparency and complexity. These changes made the transmission of defaults unpredictable, no one knew whom and where exactly default would hit.

Shady Business

To the question how Credit Default Swaps affect concrete restructuring negotiations, he answered that they did not impede negotiations, that they even might facilitate them. This may be true. Indeed the argument that CDS holders impede agreement on a haircut because they would gain from a legal default does not seem to hold: CDS holders are no longer creditors of the sovereign and thus do not participate in the negotiations. However, it also seems true and was emphasized by Jay Westbrook (Law Professor at University of Texas) that Credit Default Swaps and other derivatives make the effects of the restructuring unpredictable – effects which may include insolvencies of systemically important actors such as pension funds or insurances.

The second issue – how the finance industry impacts the political process — was largely spared. It seems however crucial, not only since opposition by major financial industry associations was one reason for the failure of

negotiations at the IMF for a Sovereign Debt Restructuring Mechanism (as pointed out by Sean Hagan, General Counsel at the IMF). I agree with John Plender's recent comment in the FT that "[t]ackling such interest groups both in the US and Europe is one of the biggest post-crisis tasks for policymakers and a key to addressing concerns about systemic legitimacy". It will be interesting to see whether this question will receive more attention at a conference with slightly (a number of speakers are identical) greater participation of public lawyers in March at the Universidad Autónoma de Madrid on Responsible Sovereign Financing. In an opening speech Armin von Bogdandy will talk about "Sovereign Debt Restructurings as Exercises of Public Authority: Towards a Decentralized Sovereign Insolvency Law."

When in his concluding remarks Christoph Paulus tentatively asked whether the questions raised by sovereign insolvency after all were not merely technical, but might call into doubt the viability of capitalism I was slightly perplexed. True, questions as to the future of capitalism, its transformations in recent times and possible reconciliation with the democratic welfare state were not discussed explicitly (except by Alessandro Somma, Professor of Law at the Università di Ferrara) but they were looming large within the Senatssaal at Humboldt University.

Why Occupy! Is Crucial

They were the questions that had brought me to this conference in the first place and which made me wonder why so few of my public law colleagues, working on questions of democracy and equality, attended. I do believe that we as academics have a responsibility to attempt to understand the workings of financial markets, their impact on society, the role of law in shaping them. We have to try to understand in order to better articulate our dismay at increased inequality, the disappearances of public libraries, swimming pools, unprofitable railroad tracks, our inability to live sustainably. I do not want to buy that this is how we need to live in the future since we lived beyond our means and now have to do our homework. (I am convinced that there are a lot of things we will need to give up in order to save the planet (such as excessive air travel or ever new electronic appliances), but I am not ready to believe that theaters, libraries, railroads, playgrounds, good public schools….must be among them).

For all the need to be rational and understand, however, it is also time to voice concern and call for reform before everything is completely understood and we can fully predict the effects – say of a financial transaction tax or the banning of over-the-counter traded derivatives. I agree with Ignacio Tirado (Law Professor at Universidad Autonomà de Madrid) that this is the moment to act, and call for stricter regulation of financial markets. This moment will pass if we wait until we have fully understood everything. We need to express our outrage now (as Alexander Somma did) at the transformation of welfare capitalism into some other form of capitalism which works well to enhance the wealth of some, but which fails to promote public welfare.

That's why I think Occupy! is so important and the criticism that it does no formulate concise demands entirely mistaken. I also am convinced that we have to bring study and protest back together (at times at least). Seeing all the black and grey suits at Humboldt University made me wish that our universities would become more colourful again – places for fundamental debate in what kind of society we want to live, places where protest is voiced and not only treated as the subject of scientific study. I was told that protests still happen at Humboldt University. At my home institution where cafeterias turn into cocktail lounges at night and auditoriums are named after banks this seems increasingly unlikely.

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