Networking Conference among like-minded Governments, Parliamentarians, Academics and NGOs on Orderly and Fair Debt Workout Mechanisms

Berlin/Germany, 12 April 2010
Friedrich-Ebert-Stiftung, Berlin & erlassjahr.de (Jubilee Germany)

An EMF with a Sovereign Insolvency Mechanism

Kunibert Raffer
http://homepage.univie.ac.at/Kunibert.Raffer

Greece's catastrophe has revived the idea of sovereign insolvency. Probably due to the no-bailout rule, even quarters highly inimical to it before could suddenly imagine this solution. Technically, some form of insolvency solution is unavoidable in the case of a bankrupt debtor, whether corporation, individual or public entity, and insolvency has proved the best option tested over centuries. Adam Smith already called sovereign insolvency least hurtful to creditors and least dishonourable to debtors.

The paper by Gros & Mayer (CEPS Policy Brief, February 2010) is the most elaborated and detailed proposal: a European Monetary Fund plus sovereign insolvency. They aptly describe the option of orderly default as "the need to prepare for failure!" Rather than being content to mobilise huge bail-outs attempting ex post to prevent failure of large institutions, the "key policy aim" should be making failure possible by containing damages, thus restoring market discipline. The EMU system should become robust enough to minimise the disruption caused by the failure of a member state. This is an excellent and economically perfectly sound point worth supporting, describing one of the roles of insolvency procedures. Indeed, "Market discipline can only be established if default is possible because its cost can be contained" – a necessary alternative to costly, dangerous, and politically problematic bail-outs ex post as done so far. Both authors, more clearly Thomas Mayer in an interview in Spiegel-online, stress the obvious interest of creditors in an orderly mechanism. Someone like I, who has so often quoted the phrase "in the best interest of creditors" from Title 11, US Code to describe one of the main features of workable and fair insolvency procedures, cannot but agree fully.

There are, however, also points of disagreement or statements where qualification is needed. The authors twice refer to Brady exchanges (initially suggested by Brazil's Minister of Finance, Bresser Pereira, then rabidly dismissed by the US Treasury) as the "successful experience" on which their "simple mechanism" should be modelled. Their proposal has little to do with Bresser Pereira/Brady, except that this exchange limited the losses of commercial banks. It also made only commercial banks lose money, illegally exempting IFIs. Giving up the illiquidity theory earlier and not engaging in forced lending would have limited these losses substantially more. Gros & Mayer seem to address only the private sector as well. What the authors propose is a re-incarnation of the idea of a public entity buying claims to hold them on the debtor country that surfaced repeatedly after 1982. J. D. Robinson's (1988) Institute of International Debt and Development comes to one's mind, the EMF replacing the BWIs, though. Unlike the wrongly cited "Brady" exchanges, where creditors exchanged syndicated debts for securitised debts of the same debtor, Gros & Mayer propose exchanging claims on the country for claims on the EMF. This is an important difference, a change of debtor: exchanging (at a discount, or fee if one prefers so) a country's bad debts for good EMF debts backed by those countries "with exceptionally strong public finances [that] would not need to contribute because they would de facto carry the burden should a crisis materialise". The bail-out would enter via the back door. As long as insurance payments by potentially eligible debtors to the EMF (1% of excess debt and excess deficit) remain insufficient, further money is needed. Logically, Gros & Mayer propose the EMF to be given "authority to borrow in the markets", i.e. from the very banks bailed out by the EMF, then holding fresh claims on it. As future contributions should finance debt service on such debts, the EMF is likely to be short of sufficient reserves to finance it without borrowing in financial markets for quite some time if it started during or because of a crisis. Creditors benefit several times: they now hold better debts (on the EMF), the EMF is now saddled with the task of collecting money form the debtor country and with the usual troubles of this relation, and banks earn money from financing this very exchange. Apparently, the EMF is only to service debts, which would limit needed resources and new EMF debts. But why should "stronger enforcement mechanisms" be of much interest to banks freed from Greek risk? The much overstressed moral hazard argument should thus be of limited interest to banks, except as a bait for politicians to make the idea more digestible.

The authors propose the Maastricht criteria as a "useful guideline" for haircuts: anything beyond 60% of GDP is to go. This seems to be a political point, aimed at pleasing politicians and the EU. Economically it makes no sense. Under fair insolvency rules debtors have to pay what they are able to pay, creditors have to get what they can reasonably expect. This may well be more than Maastricht's limit, even if civilised debtor protection norms should finally be respected when it comes to countries. On the other hand, this strict limit would allow lenders to factor in the possibility of default by simply increasing spreads accordingly. Admittedly, this builds an automatic stabiliser into the system, whose ability to prevent over-borrowing is not beyond doubt, though.

The assertion "the size of the haircut is also a political decision that will be guided by a judgement on the size of the losses that creditors can bear without becoming a source of systemic instability" makes one ask whether insolvency or bail-out are the real leitmotiv of the proposal. Logically, insolvency must remove unpayable debts (usually beyond what is purely technically unpayable due to laws protecting debtors or public interest). (Un)payable is a fact, not the result of political decision. Political decisions risk prolonging the problem, making things worse. Several "Brady countries" and "debt management" at large offer useful illustrations. But this would no longer concern banks after swaping the country's debts to EMF debt, in all probability rated AAA.

The authors propose: "Any member country could call on the funds of the EMF up to the amount it has deposited in the past (including interest), provided its fiscal adjustment programme has been approved by the Eurogroup. The country in question could thus issue public debt with a guarantee of the EMF up to this amount." Technically, any country would be better off by depositing these funds somewhere else, free to use its own money when needed and without approval by others. Unless a country is sure to need further resources from the EMF – why should it give away command over its own money?

Finally, the referral to Chapter 11 is highly misleading. First, if we actually saw Chapter 11 as the model (unaware of Chapter 9, Title 11) – why is debtor in possession (DIP) not even mentioned although it is quite frequent in the US? This would immediately solve the problem of political intrusion discussed by the authors, avoiding the problems of EMF-intrusion at least if the debtor

presented an acceptable plan. DIPs are given the rights and powers of a chapter 11 trustee, they are "in the shoes of a trustee in every way" as the Notes to §1107 explain. As DIPs have to present an acceptable plan, "adjustment measures" would nevertheless by necessity be part and parcel of procedures. §1121 ("Who may file a plan"), subsection b gives the debtor the exclusive right to file a plan during the first 120 days of the case (exceptions exist). Why should countries forced to agree to a tailor-made adjustment programme be treated worse than Chapter 11 debtors?
Not mentioning relevant details of Chapter 11 makes one muse on why the appropriate Chapter 9 is not proposed, be it by omission, because it is too transparent, open and democratic or because the authors fear that their idea might not be acceptable to politicians and orthodox circles without additional enforcement and brute force, the economic equivalent of the cavalry, although it is as legitimate and justifiable as cavalries have become nowadays.

Chapter 9 solves the problem of protecting governmental powers, and includes the affected population by a right to be heard. This is important for any public debtor with inhabitants. It works. Its greater transparency is not only fair but also more efficient because a broad discussion is more likely to produce a durable solution and will increase acceptance by the population. While an important and valuable contribution, Gros & Mayer definitely err by arguing that their proposal "is actually the only way to make the no bail-out rule credible, and thus give teeth to the threat not to bail out in reality." Adapting Chapter 9 is a better alternative, indeed the only democratically acceptable one.