Risk-free debt? The distorting promissory narrative in sovereign debt law and policy

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- Narrative

The stories that provide legal rules and policy interventions with context, meaning and legitimacy

- The problem of sovereign debt

- ‘[s]overeign finance is uniquely unforgiving of mistakes.
- There are no pre-established bankruptcy rules to adjust debtor liabilities.
- sovereign debt involves the engagement of the credit of a legal fiction – the state – for the repayment of money at some point in the future
- Sovereign debt is ineradicable absent the consent and cooperation of creditors’ (Buchheit & Gulati, 2010)

Why stories?

- Legitimacy
- Regulation, Law, and Regulators (ECB)
- Networks of governance
- Networks of influence

Legitimacy

- ‘narratives build and sustain legal norms’ (Cover 1983)
- ‘normative world, law and narrative are inseparably related. Every prescription is insistent in its demand to be located in discourse- to be supplied with history and destiny’. (id.)
- The presence of these narratives establishes that legal rules ‘are not arbitrary interventions but form stories that tend to the achievement of their outcomes.’(Benjamin, 2010)

Regulation, Law and Regulators

- The interaction is a game

- Law sets
  -the rules of the game,
  -determines the movement of players on the board,
  -the available resources
  -the objectives

- Regulators exercise their discretion through regulatory rules

- The story is a heuristic- it is a way of understanding why the game is played in the way that it is

Networks of governance/influence

- Regulators respond to the market

  - Discretion

  -the absence of a script or well-defined *a priori* rules

- Markets are governed by networks

- Regulators are a node in this network (judicial intervention, the ECB)

- Networks influence the law

- Stories are a way to reveal both

An analysis of recent EU law

- European Union Council Regulation No. 1024/2013 that gives the ECB its powers of prudential supervision of all credit institutions within the euro area (15 October 2013)

- Why? ‘Most significant transfer of powers to the ECB’ (Bloomberg, 2014)

- Recital 2. ‘The present financial and economic crisis has shown that the <u>integrity of the single currency</u> and the internal market may be threatened by the <u>fragmentation of the financial sector</u>. It is therefore essential to intensify the integration of banking supervision in order to <u>bolster the Union</u>, restore <u>financial stability</u> and lay the <u>basis for economic recovery.’</u>

- Wide ranging statutory powers to bolster the Union

ECB policy as narrative bridge

- ‘Reality’ (risks obscured from position-takers)

- ‘Imagined alternative’ (risks agreed and disclosed)

Relevance to sovereign debt obligations?

- Sovereign debt contracts (executory): exchange and planning mechanisms(disclose, agree and distribute default risk)

- To fulfil its objectives under EU law- the ECB chooses to execute debt contracts in full (removes default risk)

Why not restructure or allow default?

- Contrary to the ‘arms-length’ narrative

- Historical evidence – widespread debt restructuring (‘as old as sovereign borrowing’ (Sturzenegger & Zettelmeyer, 2006)

  -debt workouts and jubilees NOT full repayment sustain the institution of debt (Graeber, 2012)

- Creditors rarely lose out in debt workouts (CDS protection)

The promissory narrative

- Europeans always fulfil their promises’ (Sarkozy)

‘[t]he ‘French Objection’ was absolute: if you had CACs in your debt, your debt would cease to be the equivalent of money’. This resistance was shared by policy makers from Greece, Portugal and Spain. (Gelpern &Gulati, 2014)

- ‘Sovereign debt issued by European countries is superior to developing country debt
  - like US treasuries, UK Gilts and German Bunds ‘European debt is a risk-free asset class’

‘reveal the fear of Eurozone policy makers that if debt were not repaid in full as the adoption of CACs seemed to signal then Europe may become like Zimbabwe and other emerging markets.’(id.)

- In ‘reality’- fragmentation and loss of market integrity has diminished the superior risk-free status of this debt
- In the imagined alternative- when the Union is perfectly integrated- this debt will regain its superior status
- ECB policy is the bridge that is tasked to realise this imagined alternative

The promissory narrative

- Defaulting debtors are ‘rogues’ and ‘recalcitrant’ and must be sanctioned
- ‘debtors must repay their debts’

(historically this depends on who the debtors and creditors are – (Graeber)

- Legitimizes austerity (links into the ex ante efficiencies of costly defaults)

- Resistance to debt restructuring

Implications of ECB policy

- Risk-free debt (over-borrowing)

Debt markets think the euro zone debt crisis is over and are "under-pricing" the risks'.

This is leading to the anomalous situation where sovereigns such as Greece can borrow from markets when 'growth is still stagnant in Europe and a host of economic and social problems of the crisis, such as high youth unemployment, remain'.

Markets are "under-pricing" debt as interest rates remain at historic lows.

Consequently, 'Spain,… now has to pay less to get its funding from the market than the U.S., despite having much worse unemployment and growth figures than the U.S'. (April 2014)

- Overly reliant on monetary policy interventions to achieve integration

– limited room for fiscal intervention/stimulus

A new story?

- Greece and the Syriza victory
- IMF doubts about austerity
- Shifting mainstream opinion (Wolf, Krugman)
- Mckinsey Survey (2015)

‘Government debt in advanced economies increased by $19 trillion between 2007 and the second quarter of 2014’

‘Given current primary fiscal balances, interest rates, inflation, and consensus real GDP growth projections, we find that government debt-to-GDP ratios will continue to rise over the next five years in Japan (where government debt is already 234 percent of GDP), the United States, and most European countries, with the exceptions of Germany, Ireland, and Greece.’

- A new network of influence?