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Impact on State Sovereignty by Public Debt Servicing

- summary -

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SUMMARY

The issues associated with the public debt servicing have experienced a particular dynamic in the last two centuries, but especially in recent decades due to the diversification of both the categories of private credit institutions and, above all, the multilateral international financial institutions controlled by the governments of developed countries. At the same time, the issue of sovereign debt has been and still is highly topical both in the context of the global economic crisis of 2008-2010 and especially in the current pandemic circumstances, whose economic effects are already strongly felt, generating multiple concerns about their medium- and long-term evolution. On the other hand, given the limited number of scientific articles and research papers addressing the issue of national government indebtedness from a legal perspective, and especially in relation to the exercise of and impact on the state sovereignty, we consider it of interest to analyse the proposed topic by applying the filters of legal institutions and identify research directions for future developments.

The issue of public debt management has always been controversial in academic, political, legal and economic circles. The dependence of emerging and weakly developed countries on loans from various international creditors is increasing despite multiple episodes of default and repayment repudiation, almost cyclically. At the same time, the internalization of Keynesian principles of development based on budget deficits has made sovereign borrowing attractive, not only for countries in financial difficulty, but also for highly developed ones, with "living in debt" now a quasi-universal form of governance.

The picture is completed by a growing interdependence between national economies that has emerged with the general liberalization of international trade, which has created new opportunities but also new challenges for government entities. Obliged to keep pace with the dynamics of the movement of capital and goods, governments must adapt to a new paradigm of sovereignty, increasingly defined by supra-legal and supra-constitutional instruments, subordinated to the relatively new principles of soft law. The legal framework of international law has become much more flexible and fluid, often influenced by concrete and ad hoc situations analysed in real time, with national legal systems being forced *de facto* to adapt "on the fly" to changing realities.

Exporting and importing corporate governance principles is now a matter of natural course. National governments are often passive witnesses to the adaptation of the domestic business environment to the demands of multinational companies or foreign investors, who are progressively expanding their horizons in search of new markets or cheap and skilled labour.

Based on this reality, a scientific research on the evolution of this phenomenon over the last half century, in order to understand the principles underlying the construction of sovereign debt, but especially a research that follows the likely developments in the near and medium future, as well as proposals on an integrated approach to managing crisis situations, we consider them of utmost interest and of particular practical utility.

The concern with the proposed topic is rooted in the author's professional activity, both from the perspective of business law and, above all, from that of politics. A significant part of the objectives that form an integral part of this paper were identified *in vivo* by the author during the financial crisis of 2008-2010-2012, which affected Romania almost equally to all other developed countries. Starting from the observation of the heterogeneity of the

strategies and measures adopted in that period, the author's perception has given rise to several questions, to which the present study aims to find answers: Is there is a clear link between the public debt servicing and the exercise of national sovereignty, and if so, what is it? Is the domestic legal system really influenced by the lending activities of international financial institutions and private international lenders? Can the conditionalities of international creditors be *de facto* stronger than international treaties and agreements to which the state is a party? Can the lack of a legal framework regulating sovereign insolvency be used by a sovereign state to its advantage? Is there a real need to create sovereign insolvency mechanisms and procedures? What are the main obstacles to reaching political agreement on a sovereign insolvency procedure and how could they be overcome? Can sovereign credit be a *proxy* instrument in international politics?

The aim of this paper is to take a legal approach to the phenomenon of public debt, its evolution in the modern period, and to assess the impact it has had and is having on the ways in which national sovereignty is exercised. By researching the relevant international doctrine, the study follows contemporary transformations in the principles of national sovereignty and the legal order of financial systems. We pay particular attention to the steps taken towards the adoption of a unified and standardised international legal framework for the management of sovereign insolvency, with a view to obtaining practical conclusions that can take the form of public policy proposals, national strategies and, last but not least, as starting points for future research.

Through our research, we demonstrate that the evolution of the legal order of contemporary international financial systems and institutions has been strongly influenced by the political transformations of the second half of the last century. For example, if at the start of the Bretton Woods Conference negotiations, John Maynard Keynes noted that "the United States desires full discretionary powers over national central banks as per the model that they themselves apply in their own countries over domestic commercial banks"[1], the position of the other participating countries (especially the UK) has led to clear limitations on the ability and degree of direct involvement of international financial institutions in the assessment and supervision of the day-to-day activities of member states' sovereign public entities being

[1] Sidney Dell, "On Being Grandmotherly, The Evolution of IMF Conditionality", Princeton Studies in International Finance no. 144, Princeton University, 1981, (page 1); the article is available at: https://ies.princeton.edu/pdf/E144.pdf

stipulated in the IMF's Articles of Agreement. However, these "superpowers" of which Keynes spoke were later endowed with legal force by the Articles of Agreement, when the legal framework for collecting and borrowing the Fund's resources was created, being referred to generically as "appropriate guarantees"[2].

On the other hand, it is clear that conditionality has long since ceased to be an exclusive feature of international financial institutions and is widely used in most intergovernmental loan agreements. General principles such as good governance, the rule of law, respect for human rights, reforming electoral and administrative systems or strengthening democracy are frequently found alongside specific objectives such as the structure of taxes, the construction of the national budget or the reform of pension or health systems.

The thesis is constructed on the basis of five complementary chapters, continuously combining the theoretical and doctrinal component with the applied one, focusing on several heterogeneous cases, relevant in the general economy of the topic, considered by the author as real turning points in the evolutionary recalibration of global financial policies.

The first chapter of the paper opens the research by analysing the modern and contemporary evolution of the concept of sovereignty, its ways and the formal transformations that have occurred with the expansion of international and supranational organisations. Through an in-depth study of the definition of national sovereignty, of the changes in approach over the last century, but above all of the causes and contexts underlying these mutations, we have sought to draw up an accurate picture of the current global constitutional framework, which will serve as a reference point for the following chapters of the thesis. We consider as fundamental the theoretical and doctrinal delimitation of the main notions subsumed to fiscal and budgetary sovereignty, to executive or social sovereignty. In this stage of the research, we are exploring the relationship between international treaties and the role and activity of the legislative, executive and judicial powers, from the perspective of the impact on national sovereignty. Since a large part of the international legal relationships have as their source of law the international agreement, we considered it relevant for our study to understand the mechanisms and principles through which rights and obligations may

[2] Articles of Agreement, Article V(3)(a) and (4) (pages 8, 10); document available at: https://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf

arise for a sovereign state, but also the legal basis for the emergence and spread of informal and supra-legal instruments in international organisations and supranational bodies.

The second chapter highlights the most important moments in the contemporary construction of international financial legal systems. Since, in our view, the current *status quo* is the result of a long series of successive causal elements, the evolutionary observation of the fundamental transformations that took place in the modern period is of essential relevance for understanding and identifying the practical tools through which the conclusions of our research can become official position papers. At the same time, we consider the objective set in the second chapter to be indispensable, in the general economy of our research, for a complete and unified picture of the sovereign debt phenomenon from the perspective of public economic law. Also, considering the evolution of global financial, monetary and fiscal systems, which has its legal roots at the intersection of constitutional, administrative and tax law, as well as commercial and private international law, we believe that a comprehensive examination of the collateral effects of these transformations is of greater interest in defining and understanding the legal foundations of the current situation.

On this note, we analyse in this thesis the consequences that the transplantation of legal institutions and attempts to standardise national legal systems can have on the social, political and economic order of a state. We consider this topic related to the influence exercised by certain dominant states on their debtors, which is a subject of constant debate in the economic doctrine, to be interesting and useful to be analysed also through the legal filter of the functionality of the domestic law system. *Per a contrario*, we prove that the legal relationship between the debtor and creditor in sovereign loan contracts is a two-way one, as financial entities are also influenced by the particularities of the borrowing state and can even make their legal framework more flexible and adapt it in order to achieve their political objectives at a given time.

Chapter three focuses on the legal instruments involved in sovereign lending and the means and avenues of action of financial institutions and international creditors. The study takes a critical approach, assessing both successful policies promoted over time and less successful ones, seeking to reflect the main causes that have led to successive shifts in lending behaviour. The research objective in this phase of work is subordinated to the identification and research of the sources of private law, in particular with reference to

commercial and banking law and business law, as well as the transformations that these branches of law have undergone under the influence of economic policies promoted by international, sovereign or private creditors. The research also demonstrates the existence of ways in which the lending behaviour can change (at least with respect to a particular debtor government) and the means by which this can be achieved.

As the course of our study reached the component of the functional legal framework of lending institutions, we were able to demonstrate that the philosophy of action of the body of officials of financial entities is determined, to a large extent, by the theoretical and practical training of technical employees, who are, in fact, the vast majority of the American citizens. Their knowledge and understanding of the specific characteristics of the debtor countries is uneven and subjective, resulting in a tendency to standardise financing policies, which does not take into account the regional characteristics of heterogeneous social cultures. That is why we propose to internalise within these bodies a model that we consider efficient and productive, which is applied within the European institutions. By means of a flat-rate representation, pro-rated to the volume of participation quotas, Member States should have the right (and at the same time the obligation) to send their national experts to occupy executive positions. The organisational culture within these institutions should, in our view, be geared towards actively recruiting specialists from all Member States on a non-discriminatory basis.

In a fourth chapter, the research perspective focuses on the legal methods and consequences of public debt, assessing the main risks and vulnerabilities that a debtor government may face in servicing it. By drawing a brief parallel between commercial credit contracts and international loan agreements, and by referring to similarities and differences, we establish whether the latter can be classified as a subspecies of the loan contract or rather as a classic international treaty. This attempt at delimitation, with the aim of establishing the legal instruments suitable for analysing and interpreting the sovereign credit contract is important in terms of understanding the legal institutions that might subsequently be involved in sovereign insolvency proceedings.

On the other hand, we have decided that, at this stage of our research, our analysis will deal, complementary to sovereign debt, with an issue that is less debated scientifically and doctrinally, but which we believe we will show can take on the most complex and

complicated forms. We are referring here to a subspecies of the public loan contract, represented by the borrowing activity of local governments. The process itself can give rise to real issues for a national government (seen in the context of administrative law legal relationships) but can also affect the state's relationship with its international creditors by impacting on the total public debt burden. Starting from this part of chapter four, we propose to focus on two cases with similar roots but fundamentally different methods of resolution. New York City's fiscal crisis was a real turning point in the management of federal, state and local legal relationships and the United States' function as a major international creditor. At the same time, however, the budget impasse has jeopardised the city's reputation as a global financial centre, resulting in a decade-long legislative overhaul and the application of the first form of preventive arrangement to the municipality. In an attempt at a comparative analysis, we propose to explore the case of Aninoasa, (the first town in Romania to ever become insolvent). Unlike New York City, the Romanian case, even if it has a similar legal identity (but obviously a different financial perspective), captures the way in which a government chose to practically neutralise a legal municipal insolvency procedure by unilaterally paying the entire public debt from the special reserve fund, but without imposing any specific conditionalities or procedures, not even of a preventive nature.

We can safely say that the lack or ineffectiveness of clear recovery and reorganisation mechanisms in municipal insolvency makes the whole recovery process a difficult and subjective one, where political factors can jeopardise the success of the restructuring plan (for example, in the case of New York City, where the mayor at the time, Abraham Beame, represented the Democratic Party, while the President of the United States, Gerald Ford, was a Republican, the financial crisis turned into a political one, with demagogic rivalry delaying the implementation of the first measures by at least 6-9 months).

In the research, we have highlighted the existence of a predisposition of domestic law systems towards the transferring of notions and institutions of international law, even in the absence of critical debate and amendment by national legislators. The assumption of strategic objectives by the majority of political parties may, in some cases, *de facto* relativise the constitutional role of elected bodies to debate and modify, in deliberative procedures, the obligations undertaken on behalf of the state by the executive power. This aspect, especially in the area of sovereign loans, can give rise to serious sovereignty issues (seen in the classical

conception), and can have severe implications in the medium and long term if unfavourable conditions or conditionalities are undertaken. Thus, even if most countries provide for a legal ceiling for the public debt, the conditions for taking out a loan or issuing treasury bonds are negotiated on a case-by-case basis by representatives of the executive, whose responsibility cannot take any legal form but is only political before the Parliament.

Based on this conclusion, we believe that it is worth highlighting the relative and formal nature of the responsibility (legal but also political) that the representatives of the executive have over their own acts and deeds in the exercise of their public office. Thus, in the absence of criminal elements that could lead to indictment (also filtered through the benefit of immunity conferred by being a member of the government), in reality there is no real instrument in any democratic jurisdiction to hold accountable the holders of the right to contract a sovereign loan. Moreover, we observed in our study that, in order to overcome a possible veto by Parliament, most governments opt for the alternative instrument of bond issuance, which does not require the promotion of a legislative initiative.

The last chapter of the paper deals *in extenso* with the issue of sovereign insolvency, critically analysing the few prodigious initiatives launched in the recent past and the political and legal controversies they have generated. We will also explore some of the standard clauses present in international public debt contracts and the legal implications they have for domestic law systems, as well as the remedies already successfully used in public debt restructuring, even in the absence of a regulated state insolvency procedure.

Based also on empirical observations made prior to the drafting of this paper, we have identified the existence of several relevant attempts to equate sovereign default with private debtor insolvency. Each of these drafts was accompanied by a recommendation to transfer *de facto* into public law the instruments related to the company reorganisation and restructuring procedure but approached from different angles. That is why each of them is analysed from a critical multilateral perspective, in order to be able to provide a relevant answer to the hypotheses established at the beginning of the research. At a perceptual level, we consider the creation of sovereign insolvency mechanisms and procedures as a real need of the contemporary society, a belief that we seek to demonstrate scientifically, thus proving the subjective nature of the main obstacles to achieving an international political agreement on the matter.

In order to argue the vulnerabilities maintained by the current *status quo*, we have chosen to highlight, by exploring a case, as spectacular as it is topical, the uncertainties and consequences that the lack of a unified international legal framework for managing public debt crises can generate for a sovereign state. By a contextual analysis of Elliott Associates L.P. vs. Peru, we point to the ineffectiveness of the usual contractual clauses used in sovereign lending in the absence of a legal framework for the interpretation and application of the rules of international commercial law to the legal relations between a national government and its creditors.

Our research also examines, in the same final chapter, the informal ways in which a creditor constituency, composed solely of creditor governments, can be brought together by analysing the legal framework and the legitimacy of the Paris Club, a quasi-informal body that exerts perhaps the greatest influence on the conduct of sovereign creditors of all ranks worldwide. We are thus convinced that we will be able to highlight, once again, the subjective and relative nature of the functioning of international capital markets in relation to sovereign debtors, as well as the shortcomings of international law in this area.

By analysing, from an evolutionary perspective, the complexity of the legal order of international financial and monetary systems and the ideological currents that have accompanied them, we have demonstrated the empirical and even experimental nature of most of the global strategies that have been adopted since the modern era, and whose lifespan has usually been directly linked to natural economic cycles. In this context, it is clear that there is an important subjective and relative component in the process of defining the objectives of multilateral financial structures, both in terms of the economic component and, above all, in terms of the stability of the legal framework. Thus, we argue in the study, the existence of a certain degree of informal flexibility of the legal framework for the functioning of international financial bodies, under the political influence exercised by highly developed countries. The examples of their involvement, during the Cold War, in the construction of the constitutional architecture of Latin American states, or the relaxation of the application of certain provisions of the articles of agreement in the case of Romania, both episodes in the battle against communism, but with radically different legal instruments, outline the conclusion that, in predefined global contexts, sovereign credit can be used as a *proxy* instrument in international politics.

We also believe that the various schools of thought or political currents dominant at a given time also determine the behaviour patterns of technical officials, especially those of international financial institutions, towards certain debtor governments, identifying, in our research, irregular and even inconsistent behaviour towards the same debtor at different points in time. The same ideological movements also play a decisive role in defining and reforming the legal architecture of these creditor entities.

The term "conditionality" has become a common one in the political language of all indebted national governments that argue and/or base their public policies on the contractual provisions of international loan agreements. Contractual clauses that provide for obligations on the debtor state to shape and reshape public policies began to be encountered in the latter part of the 19th century in international lending processes, but much more so with the establishment of international financial institutions after the adoption of the Bretton Woods Agreement. The effectiveness and impact of conditionalities have been and are deeply controversial globally, as they are a *de facto* accepted interference of creditor institutions with the constitutional and sovereign prerogatives of debtor governments.

Conditionalities are basically concrete elements that lenders (mainly the International Monetary Fund and the World Bank Group) impose on borrowing countries in exchange for the provision of liquidity and can be predefined (such as those attached to standard financing products) or tailored to the specifics, particularities and national context of the borrowing state at a given time. Although they always vary in number and objectives and from one contract to another, they always concern macroeconomic policies such as monetary and fiscal strategy, budget spending, inflation or deflation or wage and price controls.

The subjective factor, represented by the degree of knowledge, legal and financial literacy, as well as the personal experiences and horizons of individuals temporarily in public office, are all, to the greatest extent, determinants of maintaining a balanced and responsible conduct of state indebtedness. The case explored in the second part of chapter four reveals the catastrophic potential that egocentric ambitions, vanity, selfishness or the cult of personality can have on a nation's destiny. The situation of Egypt, which has completely lost its national sovereignty for almost 80 years as a result of a chaotic and irrational debt campaign stretching over more than two decades is, in our view, a "textbook case" that should be studied in detail by any politician before entering the public office.

On the other hand, most of the political controversies arising from the implementation of conditionality packages by multilateral financial entities are due to electoral populist behaviour, invariably appearing in the social landscape of underdeveloped or emerging countries. However, our observations, drawn from an extensive analysis of several concrete situations support our conviction that the blame for the tensions that have arisen is shared almost equally between debtor and creditor. Thus, while the debtor government postpones or avoids implementing effective but unpopular measures in the naive hope that the bottlenecks will somehow resolve themselves or that another political party will end up paying for the cost of the reforms, the lending institutions always fail to catch up with the borrower's faithful cultural, social and political reality. This phenomenon, which is widespread in poorly developed countries, contributes to a negative but erroneous perception of the activity and actions of lending entities.

The phenomenon of "intolerance" towards debt confirms the perception that in certain contexts there is a predisposition of certain categories of countries to abandon a balanced attitude, which is almost always encouraged by the greed of the international capital markets, which often continue or even increase their lending activity, despite the first signs of weakening domestic economies. It is not always the case that a simple volumetric assessment of macroeconomic indicators can give the right picture of a sovereign government's situation. Looking at the case of Japan, for example, we see that, despite its status as the most indebted country in the world (with a debt ratio of more than 257% of gross domestic product), the Japanese state enjoys one of the strongest sovereign trust on the international financial markets, one of the constant concerns of its executive being the fight against deflation and falling prices. The main conclusion to be drawn from the scientific exploration of this "phenomenon" is that the political purpose of public borrowing, creditworthiness and repayment history, and the strengthening of constitutional systems and the rule of law are far more important in sovereign risk analysis than the measurement of economic and statistical indicators at a given point in time.

At the same time, the formal sovereignty of a national government can also be affected by informal or indirect means, independent of its active will. By exploring in detail the elements of risk assessment and country ratings used by multinational private companies, we have exposed a state of affairs that cascades through a whole series of macroeconomic

indicators, as well as the attractiveness of a domestic market to foreign investors and, last but not least, the bankability of the state and the costs of current public debt financing. We believe that, despite the subjectivity of some rating company technical experts as well as a host of external factors that can influence a country report, through the global recognition and legitimacy these companies enjoy, rating reports can be a positive pressure factor, holding national executives accountable to some extent.

On the other hand, by critically analysing some of the quasi-bankrupt public policies (such as the philosophy of domestic import substitution or interventionist policies) by which debtor countries in crisis worsen their financial situation, we express our firm conviction that the current political paradigm of imperfect neoliberalism offers by far the most efficient, democratic and effective legal, political and economic framework compared to the alternatives known or tried so far.

We also believe that the various schools of thought or political currents dominant at a given time determine the behaviour patterns of technical officials, especially those of international financial institutions, towards certain debtor governments, identifying in our research irregular and even inconsistent behaviour towards the same debtor at different points in time. The same ideological movements also play a decisive role in defining and reforming the legal architecture of these creditor entities.

The development of our research was achieved through the use of doctrinal, theoretical and applied resources available at this time in the legal literature in Romania, Western Europe and North America as well as local benchmarks when we focused on specific cases. The critical and its own approach is subordinated to the objectives established and listed above, filtering each element introduced in the study through the author's subjective vision, with the assumed aim of giving rise to a new perspective on a subject, as controversial as it is topical. We are also convinced that the results and conclusions of our study will form the basis of future position papers, government strategies and legislative or infra-legal initiatives, through the novel elements they will introduce into the academic debate in Romania, but also through the analytical angle through which some contemporary moments are examined.