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# Replacing Havoc: Creating Rules for Sovereign Default

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# REPLACING HAVOC: CREATING RULES FOR SOVEREIGN DEFAULT

EDWARD J. KELLEY

## ABSTRACT

Sovereign debt is an ongoing threat to a State's economic stability and its citizens' standard of living. A single occurrence of default begins a cycle in which it becomes increasingly more difficult for an indebted State to pay its debts and ensure the survival of its citizens. Because central banking systems and direct spending are often inadequate methods to boost an indebted State's economy, a more expansive solution to sovereign debt is required. The initial solution to the growing problem of sovereign debt is an international treaty that will allow the world economy to establish monitoring mechanisms to prevent debt crises before they happen and standard responses to cure defaults that do occur.

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## INTRODUCTION

Before rising to the office of United States Treasury Secretary, Timothy Geithner served as a Treasury official in the 1990s during the Latin American debt crisis. He was famously named by Time Magazine as a member of the “Sub-Committee to Save the World” for his role in fighting the crisis.<sup>1</sup> He recalls in his memoir:

[M]y main recollection from that era was how scary it was, how little we knew . . . . The economic damage was brutal, even when our interventions worked. It was scarring to see how quickly markets could overwhelm even an aggressive rescue program, how debilitating one wrong move could be . . . .<sup>2</sup>

By the time Geithner penned those sentences, he was no stranger to high stakes crisis management. He served as President of the Federal Reserve Bank of New York and later Secretary of the United States Treasury during the global financial crisis of 2008 and the subsequent global recession.<sup>3</sup> After all of that, Geithner still recognized the perilous and fragile nature of sovereign default crises.

The economic damage resulting from these types of crises is very real. It is estimated that the output losses that follow a sovereign debt crisis are about 5% per year and last for an average of ten years.<sup>4</sup> This represents a severe decrease in wealth that often occurs in States with little to no wealth to begin with. The decrease in wealth translates directly to lower living standards for all individuals within the State. Lower living standards translate to possessing fewer and lower quality tangible goods. In extreme cases, goods essential for daily survival, such as food and water, become scarce. Because these losses last for an average of ten years and are sometimes never compensated, the consequences of sovereign default become something citizens must live with on a daily basis.

Economists Carmen Reinhart and Kenneth Rogoff describe the lack of a super-national legal framework for governing international debt contracts as “perhaps the most fundamental ‘imperfection’ of international capital markets.”<sup>5</sup> This Note does not call for the creation of such a super-national organization, but, instead, proposes

<sup>1</sup> TIMOTHY F. GEITHNER, STRESS TEST: REFLECTIONS ON FINANCIAL CRISES ### (2014).

<sup>2</sup> *Id.* at 65-66.

<sup>3</sup> *About: Timothy F. Geithner (2009-2013)*, U.S. DEP’T TREASURY, <https://www.treasury.gov/about/history/Pages/tgeithner.aspx> (last visited May 1, 2016).

<sup>4</sup> Bianca De Paoli, et al., *Output Costs to Sovereign Crises: Some Empirical Estimates* 3 (Bank of Eng. Working Paper No. 362, Feb. 16, 2009), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1344294](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344294).

<sup>5</sup> CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 53 (2011).

an international treaty to normalize the market and effectively achieve the same result. The hope is that if such a system is put in place, the market will become less volatile and more resistant to sovereign default crises. The treaty proposed by this Note will set standards for debt issuance and create a crisis response mechanism to stabilize sovereign debt markets and prevent unnecessary human suffering. The standards will deal mostly with levels of debt and deficits as they are related to gross domestic product (“GDP”). The response mechanism will call for the creation of an international committee to quickly convene at a crisis’s onset and craft a plan to prevent the problems that accompany such a crisis. Part I of this Note presents necessary background in economic theory, gives real world examples of default, and notes past and present attempts at similar systems. Part II outlines the treaty, the crisis prevention measures, and the crisis response mechanisms.

### I. ECONOMIC THEORY AND HISTORY

Access to capital markets is a huge advantage to sovereign States. States have traditionally borrowed money in these markets to educate their people, industrialize their economy, and fight wars.<sup>6</sup> Without access to capital in this way, governments would be forced to increase taxes, which would take money directly out of the domestic economies. By issuing debt instead, governments are able to immediately inject the borrowed money into the economy aiming to generate more than enough wealth in the future to justify the present cost. At times, this same process can be employed to fight negative shocks in the domestic economy.<sup>7</sup> For example, if a domestic drought leads to a poor crop harvest relative to trend, the State can borrow now to import crops and repay the loan at a later time of ample production.<sup>8</sup>

States often access credit markets one day and find they are unable to make payments the next. This happens for a number of reasons including over-borrowing, failed investment, and domestic or global recession. These struggles cause immediate problems for the State and are exacerbated in a self-reinforcing positive feedback loop.<sup>9</sup> Without proper means to pay creditors, States risk default and a long-term recovery.

Debtor States also face long-term problems throughout recovery. Once a State has a history of defaulting, the markets lose confidence in the State and are less likely to loan it money in the future.<sup>10</sup> This lack of confidence forces debtor States to forgo investments that debt issuance previously made possible or accept higher interest rates that will limit the State’s spending capabilities.

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<sup>6</sup> Jaume Ventura & Hans-Joachim Voth, *Debt Miracle: Why the Country That Borrowed the Most Industrialized First*, VOX EU (July 15, 2015), <http://voxeu.org/article/debt-miracle-why-country-borrowed-most-industrialised-first>.

<sup>7</sup> Jonathan Eaton & Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, 48 REV. ECON. STUD. 289, 290 (1981).

<sup>8</sup> *Id.*

<sup>9</sup> A self-reinforcing positive feedback loop is a repeating cycle of events in which each event that occurs amplifies the severity of the next.

<sup>10</sup> Eduardo Borensztein & Ugo Panizza, *The Costs of Sovereign Default*, 10-11, (Int’l Monetary Fund Working Paper No. 08/238, Oct. 2008) <https://www.imf.org/external/pubs/ft/wp/2008/wp08238.pdf>.

Default directly hurts the people of the domestic nation. A capitalist nation's primary means of finance is taxing its people. So, when the State issues debt, the interest costs, and the eventual principal are imposed upon the citizens. Higher interest rates, then, necessarily lead to either higher taxes or more debt issuance. Also, times of default often correspond to times of recession in the defaulting nation.<sup>11</sup> Regardless of causation, recession or default will only instigate the other, and a crisis will follow. Income drops, food and water can become scarce, and black markets and crime tend to grow.<sup>12</sup> Undoubtedly, sovereign default is an occurrence best avoided.

#### A. Economic Theory

##### 1. General Macroeconomics and Recession Fighting

Gross domestic product ("GDP") measures the size of an economy.<sup>13</sup> Per its formal definition, GDP includes all final goods and services produced in an economy.<sup>14</sup> The four main components of GDP are consumption, investment, government expenditures, and net exports.<sup>15</sup> If a State has a high GDP, its people are wealthier and enjoy a higher standard of living. Because of this, governments often invest as an effort to boost GDP.

When GDP begins to fall or is at risk of falling,<sup>16</sup> governments have set up two mechanisms to boost growth. First, governments have established central banks, or other monetary authorities, tasked with adjusting the total supply of money in the domestic economy.<sup>17</sup> The goal of this is to control interest rates for various instruments within an economy.<sup>18</sup> When interest rates are low, it is easier for individuals and businesses to borrow money to finance various investments.<sup>19</sup> This will lead to the immediate use of otherwise idle resources that, ideally, lead to long-term growth. Low interest rate policies also create an incentive to consume now

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<sup>11</sup> See generally *id.*

<sup>12</sup> *Id.*

<sup>13</sup> N. GREGORY MANKIW, PRINCIPLES OF MACROECONOMICS 196 (6th ed. 2011).

<sup>14</sup> *Id.* at 198.

<sup>15</sup> *Id.* at 200-02.

<sup>16</sup> Times of falling GDP are called recessions and are usually defined as two consecutive quarters of falling GDP. Stijn Claessens & M. Ayhan Kose, *What is a Recession?*, 46 FIN. & DEV. 52, 52 (2009).

<sup>17</sup> MANKIW, *supra* note 13, at 329. The terms monetary authority and central bank will be used interchangeably throughout this note. For a more in-depth discussion of the theories of monetary policy and how monetary authorities control interest rates, see *id.* at 329-41.

<sup>18</sup> Benjamin M. Friedman & Kenneth N. Kuttner, *Implementation of Monetary Policy: How Do Central Banks Set Interest Rates?*, 1 (June 21, 2010), <http://web.williams.edu/Economics/wp/FriedmanKuttnerImplementationOfMonetaryPolicy.pdf>.

<sup>19</sup> See generally Catherine Rampell, *As Low Rates Depress Savers, Governments Reap Benefits*, N.Y. TIMES (Sept. 10, 2012), [http://www.nytimes.com/2012/09/11/business/as-low-rates-depress-savers-governments-reap-the-benefits.html?\\_r=0](http://www.nytimes.com/2012/09/11/business/as-low-rates-depress-savers-governments-reap-the-benefits.html?_r=0).

instead of save, because holding cash does not accrue much interest.<sup>20</sup> On the contrary, when the monetary authority fears an economy is growing too fast and is at risk of overheating, it raises interest rates, making that same investment more difficult which consequently encourages savings.<sup>21</sup>

The government's second mechanism to fight recession is its own direct spending. The school of thought that encourages the government to increase spending at times of recession is called Keynesianism.<sup>22</sup> Today, most economists who believe increased government spending can help a State prevent or pull out of a recession concede that government spending is only effective if the monetary authority does not respond by raising rates, and that government is most effective when interest rates are at the zero lower bound.<sup>23</sup> General economic principles explain that if the government spends, GDP necessarily increases because government spending is one of GDP's four components.<sup>24</sup> Additionally, after the initial government expenditure, economists believe there is a multiplier effect in which the money spent by the government is spent by its recipients in consumption or investment, which further boosts the economy.<sup>25</sup>

The main hurdle to government spending is that the government must in fact have money to spend. The primary way a government collects money is through taxation, but in times of recession, imposing new taxes to increase government revenue only has the effect of further retarding consumption and investment.<sup>26</sup> The

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<sup>20</sup> See Kevin L. Klieson, *Low Interest Rates Have Benefits ...and Costs*, FED. RES. BANK ST. LOUIS, <https://www.stlouisfed.org/publications/inside-the-vault/spring-2011/low-interest-rates-have-benefits-and-costs> (last visited May 13, 2016).

<sup>21</sup> See generally Rampell, *supra* note 19.

<sup>22</sup> Paul Krugman, *The New Keynesian Case for Fiscal Policy (Wonkish)*, N.Y. TIMES (Nov. 18, 2013), [http://krugman.blogs.nytimes.com/2013/11/18/the-new-keynesian-case-for-fiscal-policy-wonkish/?\\_r=0](http://krugman.blogs.nytimes.com/2013/11/18/the-new-keynesian-case-for-fiscal-policy-wonkish/?_r=0).

<sup>23</sup> See *id.*; Scott Sumner, *Why the Fiscal Multiplier is Roughly Zero*, MERCATUS CTR. (Sept. 11, 2013), <http://mercatus.org/publication/why-fiscal-multiplier-roughly-zero-0>. The zero lower bound is a technical term in economics describing the point at which the monetary authority has lowered interest rates as much as it possibly can. MANKIW, *supra* note 13, at 470. Some economists believe that at this point a central bank has no more ammunition left to fight a declining economy, while others believe there are non-traditional actions the bank can take. One specific theoretical non-traditional strategy is pushing nominal interest rates below zero into negative territory. This type of policy has not been attempted but would likely have serious repercussions for this entire Note. For a discussion of such a policy, see Benoît Cœuré, Member of the Exec. Bd. of the European Cent. Bank, *Presentation at the Annual Dinner of the ECB's Money Market Contract Group: Life Below Zero: Learning about Negative Interest Rates* (Sept. 9, 2014), <http://www.ecb.europa.eu/press/key/date/2014/html/sp140909.en.html>.

<sup>24</sup> MANKIW, *supra* note 13, at 202.

<sup>25</sup> See JOHN MAYNARD KEYNES, *A GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY* 95-105 (1936), for the theory's inception and illustrative examples, including a policy proposal encouraging the government to pay one group of people money to bury cash underground and then pay another group of individuals to dig that money up.

<sup>26</sup> MANKIW, *supra* note 13, at 121-28.

last option a government has is to engage in deficit spending<sup>27</sup> by entering capital markets to finance the additional spending. This is done by entering into a contract with another party that gives the government a certain amount of money immediately in exchange for interest payments over the course of the loan, and full repayment at a specified date.<sup>28</sup> The government then has the money it needs to engage in the second mechanism described above. The hope is that the interest payments and principal will be covered by increased economic growth resulting from the deficit spending.<sup>29</sup>

## 2. Economic Theory Specific to Sovereign Default

Government spending in excess of its tax receipts does not only occur during times of economic trouble. Often a government will decide that it needs money in addition to its tax receipts to fund things like education, industrialization, or war.<sup>30</sup> In the cases of education, industrialization, and other forward-looking capital investments, the government attempts to spend money now to increase either human or physical capital so its citizens can enjoy a higher standard of living in the future.<sup>31</sup> In cases of war, or similar investments in emergency medical research or vaccinations, the State spends money now to ensure that the country and its people survive.<sup>32</sup> Although, these investments are virtuous they sometimes fail and leave a country unable to pay back the borrowed money. When this happens, a country becomes at risk to default.

Usually, a State's inability to pay is preceded by investor unease, which manifests itself through market forces for new debt or in secondary markets.<sup>33</sup> Buyers of debt instruments will demand a higher interest rate to compensate for the risk that a State may soon default.<sup>34</sup> This makes issuing more debt unsustainable and servicing what is currently outstanding impossible.<sup>35</sup> At this point, creditors are left with few and inadequate options for recovery.<sup>36</sup> At some point, investors decide that even the higher interest rates do not justify the risk in the market.<sup>37</sup> This initiates the "rush-to-exit problem" where all investors try to withdraw their investments at the

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<sup>27</sup> Deficit spending is the amount by which spending exceeds revenue over a particular period of time.

<sup>28</sup> *Id.* at 260-61.

<sup>29</sup> *Id.* at 261.

<sup>30</sup> *Id.* at 275.

<sup>31</sup> *Id.* at 275-76.

<sup>32</sup> John Paul Koning, *How the Fed Helped Pay for World War I*, MISES DAILY (Nov. 12, 2009), <http://mises.org/library/how-fed-helped-pay-world-war-i>.

<sup>33</sup> See generally Borensztein & Panizza, *supra* note 10.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

same time.<sup>38</sup> Without access to capital, a State cannot fulfill all of its obligations and must prioritize the use of its available funds.

One secondary market worthy of discussion is the market for sovereign bonds of the State at risk of default. If market participants are worried about a State defaulting, they also tend to worry about the future value<sup>39</sup> of that State's currency for a number of reasons. First, if a State is going to default, it may decide to print more money to service its debt, which would decrease the value of present dollars.<sup>40</sup> Second, mere uncertainty of default leads to devaluation.<sup>41</sup> A State defaulting can lead to serious domestic economic and political damage.<sup>42</sup> The State's currency amidst this turmoil would then become less valuable because it is a very real possibility that the State may have to adopt a new currency in the future.<sup>43</sup>

The devaluation of the currency then affects people in the State directly. If a currency suddenly becomes less valuable, individuals who are paid in that currency see their purchasing power diminish. This means that individuals will need to expend more funds to buy the same amount of goods. There are also macro effects within an economy so that they have to spend more of their own currency to import goods. The flip side of more expensive imports is that the goods that a State exports become relatively cheaper and demand for these goods should increase. However, amidst a sovereign default crisis, the domestic economy usually slows or, in extreme cases, collapses.<sup>44</sup> Even though theory suggests that exports are cheaper and foreigners would try to purchase goods, because the economy is slowing, there may be no goods to export. In both cases, when the value of a State's currency decreases the individuals holding that currency become poorer. These individuals can afford fewer luxury goods, and, in more extreme cases, goods necessary for survival become scarce.

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<sup>38</sup> Richard Rousseau, *Solutions and Crisis Prevention for Sovereign Debt Default*, E-INT'L RELATIONS (Aug. 27, 2013), <http://www.e-ir.info/2013/08/27/solutions-and-crisis-prevention-for-sovereign-debt-default>.

<sup>39</sup> Or, in extreme cases, the future existence of that currency.

<sup>40</sup> Neil Irwin, *No, printing money won't solve the United States's debt problem*, WASH. POST (Mar. 13, 2013), <https://www.washingtonpost.com/news/wonk/wp/2013/03/13/no-printing-money-wont-solve-the-united-states-debt-problem/> ("There is certainly historical precedent for governments funding themselves through the printing press and nasty inflation resulting: Most disastrously during episodes like the hyperinflation of 1920s Germany or early 2000s Zimbabwe; more prosaically by the likes of Italy's central bank in the 1970s and 80s.").

<sup>41</sup> See generally Tejvan Pettinger, *Economic Uncertainty*, ECON. HELP (Feb. 6, 2012), <http://www.economicshelp.org/blog/4941/economics/economic-uncertainty/>.

<sup>42</sup> See, e.g., Mehreen Kahn, *What happens if Greece defaults on its International Monetary Fund loans?*, TELEGRAPH (June 30, 2012), <http://www.telegraph.co.uk/finance/economics/11511457/What-happens-if-Greece-defaults-to-the-International-Monetary-Fund.html>.

<sup>43</sup> See Brent Radcliffe, *What Causes a Currency Crisis*, INVESTOPEDIA, <http://www.investopedia.com/articles/economics/08/currency-crises.asp> (last visited May 13, 2016).

<sup>44</sup> See generally Borensztein & Panizza, *supra* note 10.



### 3. Broader Implications of Default Including Contagion

When a sovereign defaults on its debt, debtors within that State also become more likely to default on their own private debt.<sup>45</sup> This happens for a number of reasons. First, if a State defaults, it will have to cut back or completely eliminate payments to people in its own State.<sup>46</sup> These individuals then have less cash to support their budgets and may end up defaulting on their own private debt. Second, if individuals are debtors in an adjustable rate contract in which that rate is tied to other interest rates in that economy, they will see adjustable rates spike.<sup>47</sup> This means individuals will have to pay more in interest to their lenders than originally anticipated. With the value of the currency already decreasing and individuals being forced to pay more for necessary goods, they will be more likely to default on their debt obligations.

This phenomenon also has a large effect on credit markets. With an economy in freefall and uncertainty abounding, banks are less likely to loan out money.<sup>48</sup> Some individuals and businesses will be completely frozen out of credit markets, and those to whom banks are still willing to loan will have to accept much higher interest rates.<sup>49</sup> The banks are unwilling to loan because of uncertainty of repayment, and also because they are at risk of becoming cash-strapped themselves.<sup>50</sup> In advanced economies, banks are often required to retain a certain level of safer, or more liquid, assets.<sup>51</sup> These assets usually take the form of sovereign bonds, and even in the absence of mandatory holdings, banks typically own sovereign debt.<sup>52</sup> If a State defaults, the banks will see interest payments on these holdings diminish or stop accruing completely.<sup>53</sup> The diminishing interest payments will create serious solvency issues for the bank. These solvency issues are only made worse when businesses and individuals start to default as well.

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<sup>45</sup> *Id.* at 17.

<sup>46</sup> If the State were the United States, these payments would be things like Social Security benefits for retirees, unemployment benefits, food stamps, and payments to defense contractors.

<sup>47</sup> See, e.g., Annamaria Andriotis, *Mortgage rates could spike if U.S. defaults*, MARKETWATCH (Oct. 16, 2013, 6:14 AM), <http://www.marketwatch.com/story/mortgage-rates-could-spike-if-us-defaults-2013-10-15>.

<sup>48</sup> See Borensztein & Panizza, *supra* note 10, at 4.

<sup>49</sup> See Johnathon Sibun, *Credit markets frozen as banks hoard cash*, TELEGRAPH (Sept. 30, 2008, 3:18 PM), <http://www.telegraph.co.uk/finance/financialcrisis/3109892/Credit-market-frozen-as-banks-refuse-to-lend.html>.

<sup>50</sup> *Id.*

<sup>51</sup> Douglas J. Elliott, *Bank Liquidity Requirements: An Introduction and Overview*, BROOKINGS INSTITUTION (June 23, 2014), [http://www.brookings.edu/~media/research/files/papers/2014/06/23-bank-liquidity-requirements-intro-overview-elliott/23\\_bank\\_liquidity\\_requirements\\_intro\\_overview\\_elliott.pdf](http://www.brookings.edu/~media/research/files/papers/2014/06/23-bank-liquidity-requirements-intro-overview-elliott/23_bank_liquidity_requirements_intro_overview_elliott.pdf).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

Bank runs may be triggered when this cycle reaches an extreme point. In a bank run, all bank customers want to withdraw their holdings out of fear that if a bank goes under, the depositors' money will be lost forever.<sup>54</sup> The risk of bank runs causes problems for the bank, because a majority of the cash it is holding on deposit is usually loaned out, and the bank is unable to give everyone cash at one time.<sup>55</sup> This consequence of default is further along in the chain of causation and is not always reached, but is still typical of the economic catastrophe that follows sovereign default.<sup>56</sup>

These problems in one State can also affect others. In the globalization age, States are financially interconnected. Imagine the extreme case in which the United States defaults.<sup>57</sup> Imagine consequences the world would face if United States treasuries were suddenly worthless, or at least worth substantially less than what the market has priced them at today. Individuals, companies, banks, and even other governments around the world hold United States treasuries as one of the safest assets in the world. If they lost those assets and their accompanying cash flows, they would become substantially poorer both in the long and short term. Individuals could see their retirements wiped out. Businesses would have less cash to pay workers, bills, and other obligations.<sup>58</sup> Banks and other States would be in similar trouble. This contagion could also spread to other States. If the United Kingdom lost a substantial amount of money because of the United States defaults, investors will likely begin to question whether the United Kingdom would be able to service its own debts. If markets start to believe the United Kingdom is unable to, the United Kingdom would find itself in a similar situation as the United States and so on and so forth. This thought exercise is one of many reasons this Note places heavy emphasis on the need for a comprehensive international solution to sovereign default.

#### 4. Where This Leaves Us

Because of the reasons stated above, States try to avoid default. When in danger of default, a sovereign State could simply refuse to pay back its creditors, and foreign courts would have problems enforcing judgments against sovereigns unless

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<sup>54</sup> George G. Kaufman, *Bank Runs*, LIBR. ECON.& LIBERTY <http://www.econlib.org/library/Enc/BankRuns.html>.

<sup>55</sup> This phenomenon is on exhibit in Frank Capra's *It's A Wonderful Life* (Liberty Films 1946).

<sup>56</sup> Laura Noonan & Patrick Jenkins, *With cash fast running out, Greek bank failures loom*, CNBC (July 11, 2015), <http://www.cnbc.com/2015/07/11/>.

<sup>57</sup> And unimaginable not just because of its magnitude, but also because some argue it is also practically impossible. See Paul Krugman, *Deficits and the Printing Press (Somewhat Wonkish)*, N.Y. TIMES (Mar. 25, 2011), [http://krugman.blogs.nytimes.com/2011/03/25/deficits-and-the-printing-press-somewhat-wonkish/?\\_r=0](http://krugman.blogs.nytimes.com/2011/03/25/deficits-and-the-printing-press-somewhat-wonkish/?_r=0); Dylan Matthews, *Modern Monetary Theory is an unconventional take on economic theory*, WASH. POST (Feb. 18, 2012), [https://www.washingtonpost.com/business/modern-monetary-theory-is-an-unconventional-take-on-economic-strategy/2012/02/15/gIQAR8uPMR\\_story.html](https://www.washingtonpost.com/business/modern-monetary-theory-is-an-unconventional-take-on-economic-strategy/2012/02/15/gIQAR8uPMR_story.html);

<sup>58</sup> And would not be able to rely on credit for reasons discussed above.

assets exist abroad.<sup>59</sup> However, States rarely go down such a path. If sovereigns refused to pay back existing debt, they would find it extremely hard to find creditors in the future. So, instead, States at risk of default try to work with creditors, at times enlisting richer States or international organizations to help restructure their obligations so that the market keeps some faith in at-risk States.<sup>60</sup> The International Monetary Fund (“IMF”) is one such international organization that acts as a lender of last resort for national governments.<sup>61</sup> A lender of last resort is an institution a government or bank goes to when they need money to satisfy present obligations.<sup>62</sup> Nobel Prize-winning economist Paul Krugman argues that the current system with the IMF as lender of last result causes serious problems for States on the verge of default.<sup>63</sup> He argues that the IMF conditions of fiscal austerity (raising taxes and cutting spending) prior to lending only hurts the domestic economy.<sup>64</sup> Krugman’s criticisms parallel very closely the austerity-centric conditions accompanying bailouts more recently in the Eurozone.<sup>65</sup> However, as a general matter, the IMF simply is not powerful enough to resolve even moderate crises on its own, and the international community must together create a comprehensive plan to avoid catastrophe. This often includes debt-restructuring processes, which have been too slow, as shown below.

### *B. Examples of Sovereign Defaults*

#### 1. Latin American Crises

In the early 1980s Latin American States such as Brazil, Argentina, and Mexico had problems making payments on the debt that was issued in the 1960s and 1970s. These States issued debt to finance industrialization; an investment they believed would allow their economies to take off.<sup>66</sup> The crisis was brought on by new main international developments: (1) an oil price shock in the late 1970s caused current account deficits in the debtor States; and (2) a global recession in the 1980s pushed

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<sup>59</sup> See e.g., Ugo Panizza, et al., *The Economics and Law of Sovereign Debt and Default*, 47 J. ECON. LITERATURE 651 (2009).

<sup>60</sup> See generally Andrew Powell, *Bipolar Debt Restructuring: Lessons from LAC*, VOX LACEA (Feb. 24, 2011), <http://vox.lacea.org/?q=node/61>.

<sup>61</sup> PAUL KRUGMAN, *THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008*, at 115 (2008).

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> Graeme Wearden, *German Court Approves Bailout Fund, with Conditions—Eurozone Crisis as it Happened*, GUARDIAN (Sept. 12, 2012), <http://www.theguardian.com/business/2012/sep/12/eurozone-crisis-german-court-bailout-fund>.

<sup>66</sup> For a more in-depth description of industrialization projects and their eventual failure, see Guillermo Rozenwurcel, *Why Have All Development Strategies Failed in Latin America?* (U.N. World Inst. for Dev., Research Paper No. 2006/12, 2006), <https://www.wider.unu.edu/sites/default/files/rp2006-12.pdf>.

tax revenue down.<sup>67</sup> These two developments raised interest rates globally and, at the same time, caused commercial banks, which lent substantially to Latin American States in the 1970s, to shorten repayment periods, which were especially fatal to these States' economies and their ability to service their debt.<sup>68</sup>

Markets showed extreme confidence in Mexico leading up to their debt crisis. In July 1982 the returns on Mexican bonds were actually less than the returns on bonds of the World Bank, a traditionally safe borrower.<sup>69</sup> Paul Krugman describes these low returns as indicating the market's view that the chances of a Mexican default were "negligible."<sup>70</sup> Only a month later Mexican officials flew to the United States and notified the Secretary of Treasury that Mexico was on the verge of defaulting on its debts.<sup>71</sup>

Efforts to avoid catastrophic financial panic were ineffective, and a period now known as the "lost decade" followed.<sup>72</sup> Mexico's real income per capita was 10% lower in 1986 than it was in 1981, and inflation played a large role in decreasing real wages by 30%.<sup>73</sup> By 1989 Argentina's annual rate of inflation hit 3,000%, which is classified as hyper-inflation.<sup>74</sup> The reasons for hyper-inflation were many, including the fact that the States took on unsustainable debt that left them especially vulnerable to default.<sup>75</sup> When reflecting on his work as a Treasury Department staffer during the 1990s Mexican Crisis, future Treasury Secretary Timothy Geithner specifically mentioned the domestic political impediments the United States faced in its quest to put together a bailout package.<sup>76</sup> Political pressure on the international stage likely dwarfs what goes on in any domestic State. Geithner also points out the difficulty in getting the IMF to commit to bailout packages and the criticism from other States once a commitment is made.<sup>77</sup>

Finally, in 1989, the United States government reached a consensus for rescue through the Brady Plan.<sup>78</sup> Mexico began issuing Brady bonds to replace outstanding debt with debt that had a lower face value,<sup>79</sup> but the damage was done, and the pain suffered by Mexican citizens. Proactive steps like those described in later sections of

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<sup>67</sup> Jocelyn Sims & Jessie Romero, *Latin American Debt Crisis of the 1980s*, FED. RES. HIST. (Nov. 22, 2013), <http://www.federalreservehistory.org/Events/DetailView/46>.

<sup>68</sup> *Id.*

<sup>69</sup> KRUGMAN, *supra* note 61, at 33.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 34.

<sup>72</sup> Sims & Romero, *supra* note 67.

<sup>73</sup> KRUGMAN, *supra* note 61, at 34.

<sup>74</sup> *Id.* at 40.

<sup>75</sup> For an argument that these States had no choice but to accept this vulnerable position, see *id.* at 41-44.

<sup>76</sup> GEITHNER, *supra* note 1, at 46-47, 51.

<sup>77</sup> *Id.* at 49-50.

<sup>78</sup> KRUGMAN, *supra* note 61, at 36.

<sup>79</sup> *Id.*

this Note could have helped prevent the crisis and ensuing lost decade. Additionally, the lack of a fast-acting, systematic, and comprehensive mechanism for crisis management exacerbated the effects of the panic. The United States, IMF, and World Bank all worked to give assistance, but these efforts were slow and incomplete.<sup>80</sup>

## 2. Eurozone Crisis

The facts of the European Crises have been well documented and do not need to be rehashed here.<sup>81</sup> What is most germane to this Note is the ad hoc nature of the Eurozone reaction to the crises. Tim Geithner said of the crisis, “Now Europe was burning again, and it did not seem to have the tools or the desire to contain the fire.”<sup>82</sup> When the adoption of the Euro<sup>83</sup> was debated in the 1990s, a great effort was made to ensure that a sustainable shared-currency area was crafted including controls for debt issuance.<sup>84</sup> However, the policies reached to prevent and solve a sovereign default have proven inadequate. Because a default by one State within the Eurozone creates problems for all members,<sup>85</sup> powerful Eurozone States got together to craft a bailout package to help stop default in Greece, the nation most at risk of default.<sup>86</sup> Political pressures made the process slow and the original amount of the package insufficient to quell market fears.<sup>87</sup> What resulted was more pain in the States on the verge of default in the form of high unemployment, falling wages, and riots.<sup>88</sup>

### C. Efforts Toward a Similar System

After the Latin American crises, the United States encouraged States to take preventative measures to control their debt loads similar to measures proposed in this Note and modernize their economies.<sup>89</sup> Krugman explained, “State-owned companies were privatized, restrictions on imports lifted, budget deficits trimmed.”<sup>90</sup>

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<sup>80</sup> GEITHNER, *supra* note 1, at 46-57.

<sup>81</sup> For a factual history, see Vassilos G. Papavassiliou, *Financial Contagion During the European Sovereign Debt Crisis: A Selective Literature Review* 7-12 (Crisis Observatory, Research Paper No. 11/2014, 2014), [http://crisisobs.gr/wp-content/uploads/2014/06/RESEARCH-PAPER\\_11\\_Vassilios-G.-Papavassiliou-.pdf](http://crisisobs.gr/wp-content/uploads/2014/06/RESEARCH-PAPER_11_Vassilios-G.-Papavassiliou-.pdf).

<sup>82</sup> GEITHNER, *supra* note 1, at 443.

<sup>83</sup> The “Eurozone” is a term used to describe the States of the European Union that have chosen to share one currency, the Euro.

<sup>84</sup> 1997 O.J. (C 236).

<sup>85</sup> Tying multiple States to the same currency makes each State vulnerable to the economic problems of others. Papavassiliou, *supra* note 81, at 12-14.

<sup>86</sup> Luca C.M. Melchionna, *The Opportunities of Multiple Sovereign Crises, The European Market Phoenix*, 35 N.C. CENT. L. REV. 31, 38-40 (2012).

<sup>87</sup> *Id.* at 40.

<sup>88</sup> *See generally* Borensztein & Panizza, *supra* note 10. The system proposed here seeks to avoid this type of situation and is described *infra* Part II.B.3.

<sup>89</sup> GEITHNER, *supra* note 1, at 52.

<sup>90</sup> KRUGMAN, *supra* note 61, at 31.

The markets took notice, exemplifying their confidence through lower interest rates.<sup>91</sup> However, former Treasury Secretary Tim Geithner recalls that the problem with these efforts was that they were purely discretionary as the international community was unable to force sovereign nations to follow the best practices.<sup>92</sup>

More recently, a majority of the United Nations General Assembly called for the creation of a multilateral framework for sovereign debt restructuring for states at risk of default.<sup>93</sup> The General Assembly's goal is similar to that of this Note in that the drafters believe that an international system will take some of the uncertainty out of the sovereign default crisis and prevent unnecessary suffering.<sup>94</sup> In a guest post for

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<sup>91</sup> *Id.* Mexico soon thereafter suffered through another recession due to a sudden depreciation of their currency. See generally Joseph A. Whitt, *The Mexican Peso Crisis*, ECON. REV. (Jan.-Feb. 1996). This event and its causes are outside the scope of this Note as its causes were specifically monetary in nature and unrelated to sovereign debt or default.

<sup>92</sup> GEITHNER, *supra* note 1, at 52.

<sup>93</sup> G.A. Res. 68/304, at 4 (Sept. 9, 2014). Specifically, the General Assembly recognized that debt-structuring processes should be based around real payment capacity and that in the restructuring of sovereign debt:

[T]he progressive development and codification of international law are necessary in order to make it a more effective means to implement the purposes and principles of the Charter of the United Nations and to give greater importance to its role in the relations among States,

1. Emphasizes the special importance of a timely, effective, comprehensive and durable solution to the debt problems of developing countries in order to promote their inclusive economic growth and development;
2. Calls for the intensification of efforts to prevent debt crises by enhancing international financial mechanisms for crisis prevention and resolution, in cooperation with the private sector, with a view to finding solutions acceptable to all;
3. Calls upon all Member States and the United Nations system, and invites the Bretton Woods institutions and the private sector, to take appropriate measures and actions for the implementation of the commitments, agreements and decisions of the major United Nations conferences and summits, in particular those related to the question of the external debt sustainability of developing countries;
4. Recognizes the roles of the United Nations and the international financial institutions in accordance with their respective mandates, and encourages them to continue to support global efforts towards sustainable development and a durable solution to the problem of the debt of developing countries;
5. Decides to elaborate and adopt through a process of intergovernmental negotiations, as a matter of priority during its sixty-ninth session, a multilateral legal framework for sovereign debt restructuring processes with a view, inter alia, to increasing the efficiency, stability and predictability of the international financial system and achieving sustained, inclusive and equitable economic growth and sustainable development, in accordance with national circumstances and priorities;
6. Also decides to define the modalities for the intergovernmental negotiations and the adoption of the text of the multilateral legal framework at the main part of its sixty-ninth session, before the end of 2014.

*Id.*

<sup>94</sup> Yanying Li, *U.N. to Negotiate a Multilateral Legal Framework for Sovereign Debt Restructuring*, OPINIO JURIS (Sept. 16, 2014), <http://opiniojuris.org/2014/09/16/guest-post-u-n-negotiate-multilateral-legal-framework-sovereign-debt-restructuring>.

the *Financial Times*, José Antonio Ocampo of Columbia University iterates the need for a systematic solution.<sup>95</sup> He states that, given the current system, “the aspirations of the private sector for a well-functioning renegotiation process rather than a multilateral framework for debt restructuring is not viable when any minority investor can go to court to demand the original terms.”<sup>96</sup> However, United Nations resolutions are non-binding.<sup>97</sup> Therefore, a proposed treaty, which is binding international law, would be a stronger step in the right direction toward achieving the overall goal of implementing an international system.

## II. RULES TO REPLACE HAVOC

The treaty’s main goal is to detect and prevent crises. The best way to do so is to ensure that States sign the treaty at a time when they are in good fiscal standing, and bind States to levels of debt, deficits, and inflation, while still mapping out specific exceptions for circumstances when breaking the rules is justified. The second goal of the treaty is to appropriately and adequately fight crises when they do arise. This defensive goal is accomplished by empowering an elite group of economic policymakers and arming them with the appropriate tools to quickly, adequately, and equitably resolve crises.

### A. Preventing Crises Before They Happen

#### 1. The Committee

The treaty would utilize a Committee for all decision-making and rule interpretations regarding the treaty. The Committee should be made up of the top economic policy makers in the world. These include the Chairman of the Federal Reserve Bank of the United States, President of the European Central Bank, and the Director of the International Monetary Fund. The fourth and fifth members should be eastern economists, one appointed by China and the other by Russia. This is because; these two States will likely be hostile to a treaty such as the one herein proposed. Therefore, giving each of them the power to appoint a member of the Committee should incentivize their support.

The proposed composition of the Committee is not without its problems. While Russia and China are more modernized economies today than ever before, political pressures and genuine difference of economic opinion likely could lead to these two States selecting members who may clash with the western economists.<sup>98</sup> This could

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<sup>95</sup> José Antonio Ocampo, *The UN Takes the First Step to Debt Restructuring*, FIN. TIMES (Sept. 10, 2014), <http://blogs.ft.com/beyond-brics/2014/09/10/guest-post-the-un-takes-the-first-step-to-debt-restructuring>. For a more detailed analysis of the pact and some interesting projections, see Bodo Ellmers, *Sovereign Debt Restructuring: UN Takes a Big Step Forward*, EUR. NETWORK ON DEBT & DEV. (Sept. 10, 2014), <http://www.eurodad.org/Entries/view/1546256/2014/09/10/Sovereign-debt-restructuring-UN-takes-a-big-step-forward>.

<sup>96</sup> See Ocampo, *supra* note 95.

<sup>97</sup> Michelle Nichols, *U.N. to Negotiate Legal Framework for Sovereign Debt Restructuring*, REUTERS (Sept. 9, 2014), <http://www.reuters.com/article/2014/09/09/argentina-debt-un-idUSL1N0RA1X120140909>.

<sup>98</sup> See, e.g., Huiyun Feng, *China and Russia vs. the United States?*, DIPLOMAT (Mar. 2, 2015), <http://thediplomat.com/2015/03/china-and-russia-vs-the-united-states/>.

lead to imperfect actions by the Committee as a whole. On the other hand, the Committee could have economists with a better understanding of eastern economics allowing it to craft a specifically tailored and stronger resolution should an eastern State find itself in default. In either case, this treaty has a broad international aim. Without the support of Russia and China, it is as likely to be as ineffective as the League of Nations was without the United States. To create the comprehensive solution herein sought, the treaty must accept the potential risk of an imperfect Committee.

The five individuals on the Committee should rely on a staff of economists and request the resources of the international community to research and design a plan for crisis mitigation. While the Committee members have the final say, they should feel comfortable requesting the services of other top economists who either are serving in government, teaching, or working in the private sector.

## 2. Incentives to Encourage Adoption

Joining any international treaty requires that each signatory surrender a portion of its sovereignty. Potential signatories, therefore, face a tradeoff between the benefits of adoption and costs of the surrender. Here, the costs are fairly significant. Meeting the initial benchmarks for admission may require States to cut funding for popular domestic programs, raise taxes, or some combination of the two. Additionally, the good standing requirements on their face will likely hamper a State's ability to act in times of crisis. These seemingly high costs must be coupled with equally high benefits so States are encouraged to sign on.

The primary benefit of an international treaty is that if a State meets the requirements to become a member, it is less likely to default and suffer the accompanying consequences. In addition, because of the solid fiscal standing of the member States, the market will reward signatory States with lower interest rates for their sovereign debt, which will result in lower interest rates throughout the entire economy.<sup>99</sup> Lower interest rates allow the signatory States to save money while servicing its debt.<sup>100</sup> That money can then be spent in numerous ways that will allow the State to improve its citizens' standard of living. Future savings can go a long way toward offsetting the immediate costs a State might incur while meeting the membership standards.

A secondary benefit is that this treaty will guarantee States a quick and equitable resolution if they do default at some point.<sup>101</sup> Other than times of war, a State does not often face a situation as tumultuous as when it is on the verge of default. The safety net that an international coalition provides to signatory States acts as a type of mutual defense treaty. When a crisis arises, a signatory can lean on the international

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<sup>99</sup> See *infra* Parts II.A.3 & II.A.4.

<sup>100</sup> For example, if a State can lower the interest rate on their debt by even a quarter of a point, it will save twenty-five million dollars on every one billion dollars of 10-year bonds. States often have multiple billions in debt so this can add up to substantial savings.

<sup>101</sup> The hope being that this treaty will prevent the likelihood of default, but helps States safeguard against the potential dangers should default occur. For a discussion of how this is lacking in the current system, see *supra* Section II.C.



community for assistance and the certainty of adequate assistance on its own should act to quell the magnitude of the crisis.<sup>102</sup>

### 3. Requirements for Gaining Membership to the Treaty

Signatories must be in good fiscal shape at the time they join the treaty. This proposed system is not designed to magically fix a State's fiscal situation. Instead, it is a forward-looking set of guidelines to combat a serious problem in international finance. If a State enters the agreement in at least an average financial position, it should be able to improve that position over the subsequent years. Conversely, if a State is allowed to become a signatory, and has a below average financial standing, and then defaults a year or two after, confidence in the treaty will be shaken and it will be rendered ineffective even for members in good standing.

Having elucidated the importance of ensuring signatories join the compact on good standing, it is equally important to recognize the proposal of this system is happening on the heels of a global recession.<sup>103</sup> States have seen tax receipts decrease and have spent money to boost their domestic economies.<sup>104</sup> Their current debt burdens are likely at a peak rather than a valley when reviewed over the past century.<sup>105</sup> Because of the climate of recession, standards for membership understandably must be somewhat relaxed, compared to if this treaty was proposed during times of stable economic growth.

Given these circumstances, the appropriate rule should be a current debt load of 130% of domestic GDP and the most recent year's deficit less than 8%. If a State is over the 8% barrier, it must show falling deficits for at least three years, a deficit under 8% in the most recent year, and pledge to meet the good standing requirements discussed below. These thresholds generally represent sustainable debt and allow the State to abide by the good standing requirements discussed below.

### 4. Debt Requirements for Remaining a Member in Good Standing

A strong indicator of when a State is in danger of defaulting is its debt-to-GDP ratio.<sup>106</sup> Each State's situation is unique and economists have not been able to

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<sup>102</sup> For a more in depth discussion of the importance of confidence vs. uncertainty, and when the market will react, see Paul Krugman, *Bond Vigilantes and the Power of Three*, N.Y. TIMES (Dec. 24, 2012), <http://krugman.blogs.nytimes.com/2012/12/24/bond-vigilantes-and-the-power-of-three>.

<sup>103</sup> See generally *Global Economic Crisis*, YALE GLOBAL ONLINE, <http://yaleglobal.yale.edu/content/global-economic-crisis> (last visited May 13, 2016) ("The current financial crisis is the worst the world has seen since the Great Depression of the 1930s.").

<sup>104</sup> See, e.g., Mehreen Kahn, Three reasons why we're still failing to reduce the deficit, TELEGRAPH (Dec. 2, 2014, 8:45 AM), <http://www.telegraph.co.uk/finance/11168941/Why-are-we-still-failing-to-reduce-the-deficit.html> (discussing why Great Britain has failed to reduce the deficit despite economic growth).

<sup>105</sup> Richard Dobbs, et al., *Debt and (not much) deleveraging*, MCKINSEY GLOB. INST., (Feb. 2015) <http://www.mckinsey.com/global-themes/employment-and-growth/debt-and-not-much-deleveraging>.

<sup>106</sup> Carmen M. Reinhart, et al., *Debt Intolerance* 15-16 (Nat'l Bureau of Econ. Research, Working Paper 9908, 2003), <http://www.nber.org/papers/w9908.pdf>. In addition Reinhart and

establish a clear-cut threshold at which States become in danger.<sup>107</sup> For example, Japan's debt-to-GDP ratio has been above 198% since 2008 and has recently climbed over 245%,<sup>108</sup> but interest rates have remained relatively stable<sup>109</sup> and no one doubts Japan's ability to repay its debts.<sup>110</sup> Conversely, before Mexico's default, its ratio barely topped 50%.<sup>111</sup> Because debt to GDP alone would be an incomplete standard, the appropriate requirement for remaining in good standing should measure both the total amount of debt to GDP as well as the annual budget deficit. Landing on the wrong side of either of these standards will lead to a signatory State losing its good standing status.

The Eurozone has adopted a similarly structured dual-standard that States who are members of the currency union have pledged to meet.<sup>112</sup> These levels were adopted for Europe specifically based on the needs of the currency union and the ability of the States to abide.<sup>113</sup> The levels adopted are a 60% debt-to-GDP ratio and annual deficits of 3%.<sup>114</sup> These levels are less than half of the levels proposed by this Note as satisfactory for good standing. The Eurozone's levels are likely lower because European signatories crafted their own system in the late 1990s, a time that which the global economy was booming. Additionally, given the European signatories' specific fiscal situations, these levels were either attainable or already met. The treaty proposed here seeks to cast a broader net than just the mostly developed economies in Europe. It is also being proposed at a time following a great global recession opposed to a great expansion. Further, the adopted European levels were not maintainable by a number of Eurozone States. Lower levels were appropriate at the time of the Stability and Growth Pact, and higher levels are equally appropriate for this proposed treaty.

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Rogoff found that, "many other countries also suffered adverse credit events at levels of debt below 50 percent of GNP." *Id.* at 15.

<sup>107</sup> *But see* REINHART & ROGOFF, *supra* note 5, at xxv (two well-respected economists attempting to identify a threshold). Their findings were later justifiably contested. Ruth Alexander, *Reinhart, Rogoff . . . and Herndon: The student who caught out the profs*, BBC NEWS (Apr. 19, 2013), <http://www.bbc.com/news/magazine-22223190>. The authors responded with admissions but remained confident their conclusions remained valid. Carmen M. Reinhart & Kenneth S. Rogoff, *Reinhart and Rogoff: Responding to Our Critics*, N.Y. TIMES (Apr. 25, 2013), <http://www.nytimes.com/2013/04/26/opinion/reinhart-and-rogoff-responding-to-our-critics.html?pagewanted=all>.

<sup>108</sup> *'Dangerous' and 'Safe' Debt-to-GDP Ratios*, INT'L BAR ASS'N (Oct. 15, 2010), <http://www.ibanet.org/Article/Detail.aspx?ArticleUid=70fab0a8-dcde-4bcd-a412-f46dc9415ed7>.

<sup>109</sup> *Graph: Interest Rates, Government Securities, Treasury Bills for Japan*, FED. RES. BANK ST. LOUIS, <http://research.stlouisfed.org/fred2/graph/?g=SO7>.

<sup>110</sup> *'Dangerous' and 'Safe' Debt-to-GDP Ratios*, *supra* note 108.

<sup>111</sup> Rudiger Dornbusch & Alejandro Werner, *Mexico: Stabilization, Reform, and No Growth*, 1994 BROOKINGS PAPERS ON ECON. ACTIVITY 253, 295.

<sup>112</sup> 1997 O.J. (L 236/1).

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

*a. Total Debt to GDP Must Remain Below 130%*

The total debt-to-GDP measurement is calculated annually at the end of each fiscal year. If at that time, a State's outstanding debt is found to be over 130%, it will lose its good standing status. To regain this status, a State must demonstrate that, at any point in the year, its total outstanding debt has dropped below 130% of GDP for at least three consecutive months. Further, it must show that its budget for the rest of the fiscal year will remain under the 130% threshold. This will ensure that States do not just postpone payments until later in the year in an effort to regain its good standing.

*b. Annual Deficits Must Remain Below 8%*

The annual deficits measurement also will be calculated annually at the end of each fiscal year. If a State's deficit is greater than 8% of its entire budget, it will lose its good standing status. To regain good standing status after losing it because of too big a deficit, a State must run deficits below 8% for three consecutive years. The reason for the longer required time period for deficits, as opposed to debt, is because deficits are a rate while debt is a level.<sup>115</sup> The level is a more stable and immediate indicator of a State's fiscal health. The rate can be more volatile, and more time is required for a State to prove it has the rate—and thus its fiscal health—under control. If a State breaches both thresholds,<sup>116</sup> then it must meet both requirements to regain good standing status.

5. Inflation Requirements for Remaining a Member in Good Standing

The treaty must also bind signatories in terms of inflation<sup>117</sup> because ignoring the level of inflation creates a loophole that allows States to inflate their currency to pay down debt and achieve both the total debt and annual deficit levels artificially to the detriment of creditors. Creditors will see right through this strategy and demand higher interest in the inflating States making their default equally as likely as if they actually breached the debt and deficit requirements. This would upset the purpose of the treaty and diminish its value as a weapon against sovereign debt crisis. It could also have the effect of a constructive default as some of the negative consequences of default still happen when a State tries to inflate its debt away.<sup>118</sup>

Establishing a global level of inflation that would be appropriate for every State is a near impossible task. States across the world have chosen different levels of inflation based on what is most appropriate for their own domestic economies. Forcing Israel, a State whose inflation rate sustainably ranged from 10% to 19% in

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<sup>115</sup> Simon Wren-Lewis, *Confusing levels and rates of growth*, Aug. 5, 2013 <https://mainlymacro.blogspot.com/2013/08/confusing-levels-and-rates-of-growth.html>.

<sup>116</sup> This is a likely situation. As annual deficits increase so will total debt. Eventually, running enough annual deficits (especially if some grow to be greater than 8%) will lead to a breach of the total debt level.

<sup>117</sup> Inflation is an economic concept that measures the general level of prices for goods and services in an economy. MANKIWI, *supra* note 13, at 115. When the price level is rising it is called inflation, and when it is decreasing it is called deflation. *Id.* Deflation is discussed in a later subsection.

<sup>118</sup> See *infra* Section II.B-C.

the late 1980s and early 1990s,<sup>119</sup> to abide by the same standard as the United States, whose inflation rate ranged from 2.6% to 5.4% over the same period,<sup>120</sup> would cause extreme economic disruption for one or both of these States.<sup>121</sup> Each State's specific economy has its own built-in rate of inflation and changing that rate would cause significant financial instability. Therefore, there is no one-size-fits-all standard.

Instead, the best solution is to adopt inflation requirements that are specific to the past inflation experiences of each State. In order to deflate away debt, a State must increase its domestic inflation relative to its recent medium term trend.<sup>122</sup> To avoid this phenomenon, the treaty should include a binding term that will force a State to maintain a stable rate of inflation, which can be achieved by a simple rule requiring a State whose inflation rate increases to keep that increase lower than 3% above the average of the previous eight years.<sup>123</sup>

## 6. Exceptions

Generally, it is understood that there will be other domestic crises that are entirely divorced from sovereign debt crises. In these situations, a State should not be forced to leave its tools for fighting those crises on the shelf so that it can abide by this treaty. Crises that follow sovereign defaults are best avoided, but it does not make sense to avoid those crises if they are merely risked at a later date in the face of an immediate, unrelated, and remediable crisis. Below are two exceptions that should be included in the treaty. Likely, additional exceptions will be necessary. Further, a process should be included in the treaty that gives the Committee the authority to create new exceptions as they see fit. While the "special circumstances" exception gives the committee flexibility in allowing some breaches of the treaty's thresholds, giving the Committee the discretion to map out new specific exceptions will provide clear guidance to States that may find themselves in trouble. A new exception would essentially be the Committee signaling to States that, if they find themselves in a certain kind of trouble, the committee will act in an understandable manner in the future if the State has to breach the treaty.

### *a. "Special Circumstances" Exception*

In some cases a State will exceed the permitted thresholds, but feels that it has justifiable reasons for doing so. In this situation, the State can appeal to the

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<sup>119</sup> *Inflation: Consumer Prices for Israel*, FED. RES. BANK ST. LOUIS, <http://research.stlouisfed.org/fred2/series/FPCPITOTLZGISR> (last visited May 2, 2016).

<sup>120</sup> *Inflation, Consumer Prices for the United States*, FED. RES. BANK ST. LOUIS, <http://research.stlouisfed.org/fred2/series/FPCPITOTLZGUSA> (last visited May 2, 2016).

<sup>121</sup> MANKIW, *supra* note 13, at 115-20.

<sup>122</sup> In short, this is because expected inflation rates are factored into the interest rates demanded by investors in sovereign debt. The interest rate charged is calculated by adding the expected rate of inflation to the real return an investor must reap for investing in the sovereign bond. To inflate away debt, a State simply has to raise inflation above the expected market rate, cutting into the investors' real return. This allows the State to avoid default and mitigate the real costs of debt, but the market will lose confidence in the State's future commitment to honoring its debt.

<sup>123</sup> *See infra* Part I.A.5.

Committee, and if, after a formal presentation, the Committee is satisfied that the State's actions leading to its excess beyond the allowable ranges were justified it can grant the State a "special circumstances" exception allowing it to keep its good standing status. Waiting for the committee to deliberate in a time of danger makes the requested action less and less effective. Thus, the State would apply for the exception retroactively—after it has taken proactive measures.

These breaches can be justified in one of two ways. First, a State may face compelling problems specific to it that make a breach of the treaty justified. Second, global conditions affecting many States may justify a breach by many States. In both of these situations, the Committee should consider the goals of the convention generally and determine if granting a "special circumstances" exception would undermine confidence in the treaty. It then should look at the real-world consequences of the breach. If these consequences are minor<sup>124</sup> then the Committee should be more likely to grant the exception.

Some consideration may be warranted as to how many votes on the Committee should be necessary to grant the exception. A unanimity requirement may have merit, because it would make a State cautious when considering whether or not to intentionally break any of the thresholds. It may also stop States that are aligned with a majority of the Committee from breaching the standards because they know they are likely to be granted an exception. These risks are tempered by the sanction of the market, which would see right through the type of breach described in the previous sentence. In addition, there are dangers of a unanimity requirement as well. A State, in fear of not being able to rally all members of the committee, may risk allowing itself to slip into a disastrous economic situation. In some circumstances simply deliberating over whether to break the thresholds (under a unanimity regime) can cost precious time during which a State could slip into recession. Ultimately, more research is required to decide whether or not unanimity should be required for a "special circumstances" exception.

#### *b. Inflation After Deflation Exception*

At times, a domestic economy will experience falling prices. Economists call the falling prices "deflation." During periods of deflation, people who have cash hold on to it because that cash buys more tomorrow than it does today.<sup>125</sup> On its face this seems good for individuals, but it is detrimental for the economy as a whole.<sup>126</sup> Central bankers have traditionally employed extreme measures to avoid deflation<sup>127</sup>

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<sup>124</sup> For example, when there is only a minor market reaction to the limits being exceeded.

<sup>125</sup> MANKIW, *supra* note 13, at 115-20.

<sup>126</sup> See *supra* text on economic theory Section II.A. In times of deflation consumption drops dramatically, incomes sink in both real and nominal terms, and businesses close.

<sup>127</sup> Deflation was a major cause of pain during the Great Depression in the United States. Ben Bernanke was the Chairman of the Federal Reserve during the financial crisis of the late 2000s. He is perhaps the most accomplished scholar when it comes to the history of the Great Depression and undertook extreme measures as Chairman to ensure that these problems did not repeat themselves. For a speech Bernanke gave about the dangers of deflation in 2002, see Ben Bernanke, Gov., Fed. Reserve Bd., Remarks Before the National Economists Club: Deflation: Making Sure "It" Doesn't Happen Here (Nov. 21, 2002), <http://www.federalreserve.gov/boarddocs/Speeches/2002/20021121/default.htm>. For commentary on how Bernanke's scholarship affected his work as Fed Chair, see Neil Irwin,

but they are not always successful. When an economy suffers bouts of temporary deflation, the treaty should allow that State to overshoot the required inflation level without repercussions in order to recover from the recession that likely accompanied the deflation. Further, deflation is a negative rate of inflation that decreases the eight-year average, potentially by a substantial amount. This would handcuff a State in a way this treaty does not intend.<sup>128</sup> Because of this, a State will not be penalized for violating the inflation rule if it has experienced deflation in the past three years.

#### 7. Enforcement Mechanisms

Enforcement mechanisms, that ensure fidelity to the treaty's terms, are essential to the treaty's existence and success. However, traditional economic sanctions, such as trade barriers or restrictions on financial transactions,<sup>129</sup> are not appropriate mechanisms to address a treaty violation since these traditional sanctions only further exacerbate the economic problems the breaching State faces domestically. A major goal of the treaty is to promote economic stability, and adding sanctions to an already unstable economy only aggravates the instability.

An alternative mechanism, typical of similar international treaties, is to strip a State in breach of some of the treaty's benefits.<sup>130</sup> However, it would not make sense here to strip a State who loses its good standing of the benefits. If a State lost those rights, it would almost definitely preclude the triggering of the mechanisms outlined in Part II.B. of this Note. States would lose a major incentive of joining the treaty, and the major safety blanket designed to provide protection at this vulnerable time. Therefore, stripping States of Part II.B. rights would not be an appropriate enforcement mechanism.

The best mechanism to ensure fidelity to the treaty's terms is likely the natural market reaction to which a State in violation of the treaty's terms will be subject. If a State breaks the treaty's thresholds the market will become nervous about that State's ability to continue servicing its debt. Market vigilantes will see that a State broke a clear and explicit commitment to certain levels of debt, deficits, and inflation and punish that State with a diminished willingness to lend money at favorable rates.<sup>131</sup> Once it is apparent that a State is at risk of default, likely a short time after the market vigilantes snap into action, the quick resolution processes described below should begin. Ultimately, breaching the standards comes with its own, automatic sanction.

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*Why We Shouldn't Think of Central Bankers as Hawks and Doves*, WASH. POST (July 30, 2013), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/07/30/why-we-shouldnt-think-of-central-bankers-as-hawks-and-doves> (describing Bernanke as a "deflation hawk" and arguing that his primary concern is taking all appropriate measures to ensure deflation does not happen in the United States).

<sup>128</sup> Deflation makes it harder to pay back debts. It is the reverse of inflating debt away. It makes the real interest rate greater.

<sup>129</sup> For a discussion on economic sanctions see David A. Baldwin & Robert A. Pape, *Evaluating Economic Sanctions*, 23 INT'L SECURITY 189 (1998).

<sup>130</sup> Vienna Convention on the Law of Treaties, art. 60, May 23, 1969, 1155 U.N.T.S. 331.

<sup>131</sup> The "Market Vigilante" argument is often overblown domestically in the United States but there are plenty of developing and even developed nations who are likely to feel this effect at times of higher debt, deficits, and inflation. See Krugman, *supra* note 102.

### *B. Quick Responses When Crises Do Happen*

The treaty's safety net is only effective if the Committee has the requisite power to act quickly. The following outline should ensure that the safety net is sufficiently powerful and structured in a way to enable quick decision-making.

#### 1. The Boilerplate Provision

All signatories of the treaty must agree to include a boilerplate provision in the terms of their sovereign bonds and explicitly and unequivocally must state that both bond issuers and bondholders agree to be bound by the terms of this treaty and decisions of the Committee. The boilerplate provision ensures that the committee has the absolute authority to issue appropriate relief as it sees fit. The treaty should include language that makes the boilerplate provision binding law in as many States as possible.<sup>132</sup> The provision should be written broadly with the goal of establishing a clause that is binding in every State that may join the treaty.

#### 2. When Things Go Bad—The Committee's Mandate

The central principles of the crisis resolution procedures are quick, adequate, and equitable relief. The process must be quick so as to get ahead of a problem before it can escalate any further. Indecisiveness only exacerbates the reactions of market participants. The result must be adequate to quell the panic. When faced with the risk of undershooting its goal and overshooting its goal, the Committee should always err on the side of caution and try to overshoot. The result must also be equitable because if market participants believe they are getting a raw deal when relief is granted they will stay out of the market or at least demand a higher risk premium.

The methods of rescue employed by the Committee should include bailouts, loans, and debt restructuring as allowed by the boilerplate provision. The Committee, because of its members' positions as top economists, should have broad discretion as to the most appropriate combination of relief to be granted in accordance with its mandate. The Committee is permitted, and it should, solicit the opinions of anyone it feels can aid in the fulfillment of its mandate.

#### 3. Debt Held by the Sovereign State

Often, a State will be the owner of its own bonds. The most well-known example of this is the Social Security trust funds. The Social Security trust fund is funded through taxation, and when taxes collected are greater than the current obligations of the Social Security Administration so that it holds excess cash, that cash is invested in bonds, which, as required by law, must be backed by the full faith and credit of

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<sup>132</sup> See *infra* Section II.C for a discussion on the self-executing/non-self-executing dichotomy. Those same dynamics should be considered here.

the United States.<sup>133</sup> This allows the trust fund to earn interest on idle money through what is thought to be one of the safest securities in the world.<sup>134</sup>

In cases of default where the issuing State owns some of its own bonds, that State has a duty to report an accurate accounting of these bonds to the Committee. The Committee then considers these holdings when rendering its final resolution and shall have the authority to mandate that the issuing State take a haircut<sup>135</sup> on these bonds, which is greater than the haircut the other creditors will take. However, in doing so the Committee must consider the effect this haircut will have on a State's future solvency. It would not be consistent with the goals of the treaty to impose such a large haircut on a State that they will find themselves on the verge of default again in the next five to ten years.

### C. Making the Treaty Operational

In the United States, treaties are considered to be in one of two categories: Self-executing or non-self-executing. A self-executing treaty is one that takes force upon its execution, while a non-self-executing treaty requires subsequent legislation to give the treaty force domestically.<sup>136</sup> Every State has different requirements for making treaties operational, so this treaty should be written broadly as to have an immediate effect in all signatory States. It should include far-reaching language so that the treaty's system will go into effect immediately upon the treaty's execution in each of the signatory States. This broad language coupled with the boilerplate provision ensures that the treaty is legally binding on all signatory debtors and their creditors.

### CONCLUSION

As shown, the international system lacks a mechanism for quick resolution of sovereign default crises. Without such a system, States are constantly at risk of experiencing major economic distress. Creating a mechanism to combat default and coupling it with binding standards by which States must abide when issuing debt will help prevent sovereign default and the accompanying unnecessary human suffering. Reaching an international consensus will be difficult, but a comprehensive system that is sufficiently preventative will convince all States, regardless of their own debt levels, to adopt this system on its merits.

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<sup>133</sup> See *Special Issue Securities*, SOC. SECURITY ADMIN., <http://www.ssa.gov/oact/progdata/specialissues.html> (last visited May 2, 2016); see also Kevin Drum, *For the Last Time, the Social Security Trust Fund Is Real*, MOTHER JONES (Dec. 14, 2012), <http://www.motherjones.com/kevin-drum/2012/12/social-security-trust-fund-is-real>.

<sup>134</sup> See Russ Wiles, *Social Security is still one of your safest investments*, USA TODAY (Oct. 15, 2015), <http://www.usatoday.com/story/money/personalfinance/2015/10/15/social-security-still-one-your-safest-investments/73893730/>.

<sup>135</sup> "A haircut is the difference between prices at which a market maker can buy and sell a security. The term comes from the fact that market makers can trade at such a thin spread." *What is a 'Haircut'*, INVESTOPEDIA, <http://www.investopedia.com/terms/h/haircut.asp> (last visited May 13, 2016).

<sup>136</sup> See Carlos Manuel Vazquez, *Treaties as Law of the Land: The Supremacy Clause and the Judicial Enforcement of Treaties*, 122 HARV. L. REV. 599, 650-51 (2008).



