NEW CORPORATE TECHNIQUES FOR FINANCING DEVELOPMENT: THE AFTERMATH OF THE EUROPEAN SOVEREIGN DEBT CRISIS

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APRIL 4, 2012

PROLAW
LOYOLA UNIVERSITY OF CHICAGO SCHOOL OF LAW
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ROME, ITALY

CRITICAL ESSAY:

NEW CORPORATE TECHNIQUES FOR FINANCING DEVELOPMENT: THE AFTERMATH OF THE EUROPEAN SOVEREIGN DEBT CRISIS

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INTRODUCTION

It is a great honor for me to submit this Critical Essay for inclusion in the inaugural edition of the PROLAW Journal (July 2012). It is a pleasure to be invited to participate in the launch of this important new venture. This essay expands the analysis of a one-day seminar that I led on March 30, 2012 at the John Felice Center, PROLAW's Rome campus.

My intent in teaching this seminar was two-fold: first, to update my own analysis and thinking regarding the changing global context of international development that now included issues concerning Europe's sovereign debt crisis (a new subject for me), and second, to introduce my students to new corporate financing techniques that support development.

This was a sea change for me as well since I created an in-class exercise that involved an M&A transaction where an Indian IT company was acquiring a French IT firm. One student asked in essence, "why are we doing traditional corporate transactions instead of focusing on development finance?" His surprise was echoed by own. I never expected to change development finance from the standard loans, loan guarantees, partial credit guarantees, etc. to more familiar corporate forms of M&A and related corporate finance techniques. I realized very quickly that it is not the transactions that have really changed but their application to a dynamic and rapidly evolving emerging capital finance market. Thus, my goal was to introduce my students to a "brave new world" where long-standing assumptions concerning development finance and its applicability to developing countries needed to be re-thought and recalibrated for newly emerging countries and emerging financial markets.

In fact, let me express my surprise in finding myself to be *required* to address questions of European sovereign debt, fiscal deficits and related issues in this context. My entire academic career has been exclusively focused on developing countries—specifically, defining the legal architecture between emerging economies and

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advanced nations. Much to my surprise and even shock, the framework of my analysis that generally consisted of a detailed examination of sovereign borrowing practices and their negative impact on development, the role of the International Monetary Fund (IMF) in debt restructuring and how best to encourage capital market growth and related issues may now be applied to a European context. The sovereign debt crisis has truly become a global phenomenon. In light of this unexpected development, this essay will examine the impact and ramifications of the current European debt crisis on the future financing needs in emerging economies.

More specifically, the European sovereign debt crisis will be compared to previous debt crises in Asia and Latin America. What can emerging economies learn from Europe, and what can Europe learn from developing countries? In light of mutual lessons learned, what approaches should be taken by developing nations in terms of sourcing financing for their needs in a vastly changing global financial environment? In other words, what corporate techniques are most useful in rapidly changing and dynamic international financial markets?

An Overview of Banking Functions: The primary function of a bank is to provide financial intermediation between savers and borrowers. In other words, banks provide safe repositories for savings that are then circulated in the local economy in the form of loans to creditworthy borrowers. A bank's capital is the net value of its assets (loans or payments receivable on a date certain) and liabilities (deposit or obligations to pay on demand). If the banks' assets (or equity) decline, there is a corresponding decline in the bank's capital and bank decapitalization, over time, leads to insolvency. Government regulators may step in to reduce the likelihood of bank insolvency by imposing capital adequacy requirements, or requiring banks to maintain a certain level of adequate bank capital. But as we know, bank regulation is not looked upon favorably in deregulated capital markets.

There is a corresponding risk in an era of bank globalization where banks establish overseas branches and engage in cross-border lending. The risks inherent in international banking are: (1) systemic bank failure where the entire banking system collapses; (2) a solvency risk where depositors may not be adequately protected from losing their savings; and (3) the lack or regulation of illegal banking activities such as the failure to prevent money laundering, illegal transactions and the like.

Bank failure rises to the level of a sovereign debt crisis when there is a "perfect storm" of factors that lead to a *lack of liquidity* (i.e., insufficient short-term or liquid assets to pay for the bank's

liabilities resulting in a cash flow problem) or a *lack of solvency* where the bank's debt overhang prevents fresh new investments being made requiring its principal creditors to forgive a portion of its debt. If this is not possible, then the bank must examine the options of declaring bankruptcy and folding its operations.

How do you tell the difference between a lack or liquidity and actual insolvency? We will return to this question as we explore the ramifications of the European sovereign debt crisis.

Europe: What Went Wrong? For European countries that joined the Economic and Monetary Union (EMU), they adopted the euro (€) thereby eliminating the exchange rate risk and lowering their borrowing costs. (Greece, for example, could not join the EMU in 1999, but was admitted in 2001 after making fiscal changes which were arguably still not strong enough to allow its admission.)

Europe is now dealing with two interrelated crises: first, a banking crisis, stemming from losses in capital market securities (including U.S. subprime and other structured financial products); and second, a sovereign debt crisis exacerbated by excessive borrowing to finance social benefits, real estate and higher wages which led to an overall decrease in global competitiveness over time. Cross-border lending at low interest rates to so-called peripheral economies (i.e., Greece, Portugal, Italy, Ireland, and Spain) led to high domestic spending, higher wages and more imports. Further, there were no new taxes or savings that ultimately led to a buildup of fiscal deficits. This, combined with a prolonged recession, was a perfect storm.

The immediate consequences of any sovereign debt crisis is entirely predictable: (1) a reduction in the real value of assets, stocks, housing prices: (2) a rise in unemployment, inflation, taxes and the cost of living; (3) a curtailment of government-issued benefits cutting into social safety nets in housing, retirement benefits and education; (4) reduced productivity leading to a sharp decline in the Gross Domestic Product (GDP); and (5) social unrest (e.g., riots) and political instability (e.g., changes in governments in Italy and Greece). The risks of this European crisis are a sovereign default by the country involved and financial contagion that could affect capital markets in the U.S. and beyond.

As sovereign debt crises are not new, it is important to look back at history to trace the causes and effects. The initial problem with sovereign debt crises is that, generally speaking, a solvency crisis is mistaken for a liquidity crisis. This means that cash is poured into the distressed economy to meet interest servicing needs on external loans without realizing that systemic, structural economic

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problems are leading the country into insolvency. Thus, insufficient debt relief is offered to the country in distress that is unable to meet its external debt obligations.

Additionally, there are too many actors, including private creditors (organized into bank advisory committees), the IMF (the lender of last resort) and whose lending is highly conditioned on severe austerity measures, and domestic creditors. The usual prescriptions for restoring fiscal health are well-known: cut jobs especially in the public sector, raise taxes, lower wages, decrease or eliminate government benefits—all designed to cut imports and encourage exports. While these austerity measures are well-meaning they inevitably cause recessionary conditions further exacerbating the economic pain being felt by the indebted country.

Of course, the one remedy available to other nations is not available to Eurozone countries—devaluing their currency. But a bailout by other Eurozone nations and/or the IMF is an available option, and one that is being used now frantically to stave off an actual sovereign default on debt.

Greece in Crisis: The European Central Bank (which by the terms of the Maastricht Treaty is not allowed to be the lender of last resort), and IMF (which is allowed to be the lender of last resort) bought the bulk of Greece's outstanding sovereign bonds in May 2010 in a three-year bailout of US$146 million in an attempt to stabilize Greece's bond market. IMF-imposed austerity measures included improving tax collection, freezing public sector salaries, increasing the retirement age from 52 to 67, and creating a permanent team to oversee the implementation of these and other austerity measures. Both Greece's and Italy's Prime Ministers resigned leaving new leaders, Lucas Papademos (Greece) and Mario Monti (Italy) to oversee the new austerity regime.

Predictably, this proved to be insufficient. In February 2012, a new bailout of €130billion (US$172 billion) was approved. The European Financial Stability Facility (EFSF), a Luxembourg-registered company owned by Euro Area Member States, was created in June 2010 to provide temporary rescue funds. The EFSF is backed by guarantees from Member States for a total of €440 billion, not all of which has been expended at the time of this writing. Further, the European Stability Mechanism, a permanent fund will be created in July 2012, and will provide €500 billion (US$660 billion) to stem the European sovereign debt crisis.

Greek government bonds that are maturing over the next three years are being exchanged at a 50% face value discount for new

30-year "Brady" exit bonds issued by the EFSF. In other words, loans are being swapped for bonds. However, Greece may have something to learn from Côte d'Ivoire in this context. Ecuador defaulted on its Brady bonds (named after former Secretary of the U.S. Treasury, Nicholas Brady) in 1999, followed by Argentina. Both went back to the international bond market for another bond swap. Côte d'Ivoire defaulted on its Brady bonds in 2000, but went to the London Cub, an informal conglomerate of commercial bank lenders, and not to the bond market. The lesson of experience may be that if sovereign bonds are not traded on the open bond market but by the banks issuing the bonds in the first place, the bonds will not be traded as "bonds" but behave like "loans." Therefore, the entire purpose of converting loans into sovereign bonds will be lost.

Greece may also have something to learn from Iceland's unorthodox approach of imposing currency controls to prevent capital flight of massive outflows of capital. It also did not "socialize" the capital losses of its banks but allowed them to fail. Iceland did not leave the EMU or re-adopt the kroner thus permitting it to devalue its currency, but it instead strengthened its welfare state, decreasing inequality while recovering from a debt crisis.

However, the severity of the political dislocation that financial crises may create cannot be ignored. The trial of Iceland's former Prime Minister, Geir Haarde, began on February 4, 2012. He is being tried for his role in the 2008 financial crisis. While "[s]ome have argued that Iceland's financial meltdown was tied to the global crisis, and that the government could not have predicted or prevented it. But a parliament-commissioned report put much of the blame on Haarde and his government, saying that officials 'lacked both the power and the courage to set reasonable limits to the financial system.'"[1]

Mario Draghi, President of the European Central Bank (ECB), quietly issued cheap credit to European banks at low interest rates in December 2011, much like the U.S. Federal Reserve did in 2011, announcing a second round of "quantitative easing" (dubbed "QE2") where US$900 billion in long-term treasuries (bonds) would be made in order to stimulate the U.S. economy. The impact in Europe of the cheap credit raises the specter (no pun intended) of zombie banks who may continue to issue bad loans and buy Italian and Spanish government bonds instead of lending

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to private businesses, cleaning out bad assets and reforming their balance sheets.

What is Different about Europe? Well, first of all, it's Europe! Moreover, unlike a federal economy like the United States where a flagging California may not necessarily affect New York, there is no centralized budget for EMU countries and a single currency prevents devaluation by a single member state. (Of course a devalued currency would create cheaper goods and improve exportability and productivity.) Further, Greece, Portugal, Ireland, Italy and Spain are all in crisis at the same time, compounding the problem. Further, by law, the ECB may not be the lender of last resort.

What may be learned from past sovereign debt crises in Mexico (1994), Thailand (1997) and Russia (1998)? These were all currency crises (an inability to keep their balance of payments current) that turned into sovereign debt crises. The Asian debt crisis, for example, had many of the same underlying economic conditions plaguing Europe: (1) budget deficits); (2) out of control domestic bank lending fueled by cheap credit available at low interest rates; (3) overvalued exchange rates; (4) poor banking supervision. When foreign investors realized that their investments were no longer yielding high returns, they withdrew their capital. These highly volatile and unpredictable capital outflows were disastrous. The reversal of capital flows in Thailand where low-interest rate foreign currency denominated loans were invested in non-movable real estate ultimately caused a contagion effect in Malaysia, Indonesia and other Asian countries.

The macro-policy environment is also strikingly similar to Europe, namely, global liquidity combined with poor bank supervision, the lack of due diligence by cross-border lenders, and current account deficits being financed by unhedged capital inflows that may be quickly reversed. The debt bailouts in Greece are already showing signs of failing since their focus has been on maintaining liquidity rather than addressing insolvency.

What Can Europe Learn from Asia and Vice Versa? The lessons of experience from Asia are first, to build up its foreign exchange reserves as a cash cushion. This is a sort of self-insurance so that these countries never have to resort to highly conditioned, politically painful IMF-funded structural adjustment loans. (Emerging nations have, no doubt, noticed that the same IMF prescriptions that they had to endure are meeting with the same resistance by their European counterparts.) Establishing flexible exchange rates (not so much of an option for EMU states) and

strengthening financial systems, market regulation, capital controls were all part of the Asian response. Further, addressing systemic issues such as improving transparency, governance and controlling corruption were also key elements in overcoming the sovereign debt crises.

In Asia, specific challenges centered on creating a more liberal business climate, supporting more infrastructure growth and eliminating poverty and inequity in their societies, which are not problems that Europe is dealing with. Ultimately, however, whether one is speaking of Europe, the U.S., or anywhere else, the magic formula is growing the economy, balancing the budget and accumulating savings—obviously easier said than done!

A Firewall Against Contagion: Interestingly, the IMF is very focused on establishing a firewall by seeking US$200 billion from Europe and US$300 billion from non-EMU Europe, Brazil, Russia, India and China (the so-called BRIC countries.) The spreading of the painful structural adjustments in the global economy is now being distributed to emerging economies, an important sea change. The IMF has also made dire predictions that the economic downturn in Europe could cut China's growth in half since China is such a big exporter to Europe. Australia, New Zealand, South Korea and Vietnam are the most exposed to Euro Area contagion with Indonesia and the Philippines being the least exposed.

The Great Convergence: The Industrial Revolution and its aftermath caused a great divergence between the West and the Rest by imposing colonialism, preferential trade relations, and limiting the access to technology and markets. Now, emerging nations are adopting the technology, know-how, and Rule of Law and institutions of the West. They are successfully accessing Western markets without incurring a debilitating debt overhang. There is also a new divergence where the West's dwindling population is aging, consumer-based and debt-ridden whereas the Rest is younger, more innovative and able to save rather than spend. The West is concentrated in highly skilled labor and products whereas the Rest has workers with lower skills but who produce more goods and generate higher productivity and profits.

Nevertheless, the advantages of the West should not be overlooked such as a friendlier business climate, better regulated and transparent markets, tax-friendly regimes, and more reliable courts. The sophisticated markets, technology and luxury goods and industries of the West also make it an attractive investment destination. Moreover, the reliable liquid bond market for making

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safe investments by emerging economies is also a plus, although it does reveal the huge imbalance between the savings of the Rest in relation to the West.

A Brave New World: The global economy has shifted in remarkable ways over the past decade or so. Rather than viewing the changes with trepidation and fear, this is an opportunity to rebalance the equation in important ways. The response of emerging markets to new developments in global markets are difficult to gauge, but certain trends are significant and should be discussed in this context. Emerging economies have different corporate structures, management styles, innovation techniques and vastly different long and short-term goals.

Different Corporate Structures: Many emerging economies have state-owned enterprises that have a hybrid character. It may not be fair to characterize them simply as nationalized companies since they may borrow from international credit markets and act like private companies in many other ways. Many countries also have diversified conglomerates that are essentially family owned and run businesses that may sell everything from toothpaste to cars. Further, there may not be a single industrial paradigm as China is specialized in manufacturing, India in services and Brazil and Russia in commodities, especially in the energy sector.

Different Management Styles: The management styles in emerging markets may also come as a surprise from the more classically educated Harvard MBA graduates. Emerging markets may use “scaling out” or a horizontal wider use of employees in production and distribution by using mobile phones and the internet—this captures synergies in the use of manpower and limited infrastructure. Emerging markets may also use mass production techniques in the most surprising ways such as lining up patients for eye surgery so that when one is finished, the next patient is already in line!

Different Innovation Techniques: Emerging markets often use what is called “frugal innovation” whereby they sparingly use raw materials and recycle them with a view to preserving rather than squandering raw and finished products, thereby lessening the environmental impact of such technologies. They may also overcome the lack of infrastructure by developing solar-powered batteries, generators for lack of electricity and mobile phones to connect televisions to the internet, for example, or to engage in banking transactions. This value-added frugality works well in austere times.

Different Long and Short-Term Investment Goals: In the short-term, emerging economies are very interested in accessing global financial markets and participating fully in them as relevant players. In the long-term, changing laws, financial and legal structures and institutions, and regulation is a long and ongoing endeavor. This time is being used, if it is to be used wisely, to strengthen domestic capital markets, mobilize savings domestically, create a better investment climate and attract domestic and international investors. This time should also be used to create better macro-economic policies, laws and judicial frameworks for protecting rights and enforcing judgments.

However, the most important overall investment in the future may be in education. While a review of the differences in educational policies, practices and results between Western economies and emerging ones lies outside the scope of the paper, it is clear that 50% of all U.S. engineering degrees are conferred on Chinese and Indian students. Thus, perhaps creating a pool of educated graduates who understand the mathematics, technology, and practical aspects of business is the best way to innovate a brighter future.

In the past, I wrote extensively on privatization techniques and different ways of forging public-private partnerships to attract necessary foreign capital to make capital investments in infrastructure and other necessary sectors of emerging economies. Now, I find that I have to shift my analysis somewhat to take into account two relatively new methods of financing development in emerging economies.

The first is Foreign Direct Investment (FDI) which should sound eerily familiar. A great deal of attention has been spent over the past several decades on FDI being a new form of Western domination where international corporations acting in concert with host governments to tackle major infrastructure projects (e.g., power generation, water, airports, seaports, schools, hospitals, telecommunications). However, what I mean by FDI is not attracting foreign capital into a host country but rather having the host country acquire the assets of a Western company. This "reverse FDI" is particularly significant since many countries are using Mergers & Acquisitions (M&A) to acquire full or controlling ownership over Western companies.

China, Israel, the UAE, India and Singapore are now acquiring target companies in the U.S., Spain, Canada, Australia and the UK. This is surprising in light of diminishing returns from advanced

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countries, but also understandable as M&As give emerging economies access to advanced markets, branding, new technology, better skilled workers, and other business and tax advantages. For example, Tata, an Indian conglomerate, has recently acquired Jaguar Land Rover, Tetley Tea, and Corus Steel. I have to admit that I was a bit taken aback by this since I drive a Jaguar and did not want the company to turn into a "masala" Indian company (despite my Indian origin).

Happily, my concerns were unfounded since nothing really has changed. And this is the interesting aspect of reverse FDI acquisitions—they are not designed to assert new ownership in a palpable way but rather designed to create new, innovate products by keeping the existing workplace in place and adding to the local economy. The lack of disruption in the production, management style and branding has been met with relief in most quarters.

In fact, in getting back to an earlier point, M&A transactions allow emerging economies to mobilize domestic savings, use international financing in the form of syndicated bank loans, bond issuances in foreign currency denominations, or stock purchases in effective ways. M&As gives emerging economies access to diverse capital and consumer markets, and gives more time for them to develop their own capital markets at home.

The second relatively new corporate financing technique is Foreign Portfolio Investment (FPI) which should also sound very familiar. But here again, it is reverse FPI since Sovereign Wealth Funds (SWFs) are being used to make portfolio investments in Western companies and industrial sectors. I have written extensively on SWFs, and that discussion does not merit a reiteration here, but suffice it say that emerging economies are using their surplus foreign currency reserves to purchase strategic foreign assets for a profitable return on their investment. Seeking better returns than what is available on U.S. or European government-issued bonds is a changing investment strategy of developing countries.

Conclusion: In conclusion, certain trends may be discerned, first, that the sovereign debt crisis is now a global phenomenon; and second, that we are witnessing a reversal of capital flows from the Rest to the West.

Finally, we are all entering a Brave New World where the aging and some might say, profligate West is now confronting a younger, more innovative world with very different short and long-term objectives. The objective in acquiring Western companies and other assets is not so much about exerting political or economic

domination as it was with the West during the colonial, post-colonial period and beyond. It may simply be to secure a more profitable and secure future for their country in the immediate term and for future generations in the long-term. In any case, like the Chinese proverb, we do indeed live in interesting times.

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ENDNOTES

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[1] "Trial of former prime minister of Iceland begins," *The Guardian* (March 4, 2012), available at http://www.guardian.co.uk/world/2012/mar/05/iceland-pm-charged-crisis?newsfeed=true (last visited on March 6, 2012).

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