A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal*

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1 Introduction

The sovereign debt crisis in the euro area during the spring of 2010 has revealed that the monetary and fiscal policy framework of the European Monetary Union (EMU) is still incomplete. Obviously, the rules-based framework for fiscal policy created by the Excessive Deficit Procedure and the Stability and Growth Pact was insufficient to prevent a debt crisis despite its emphasis on keeping public sector deficits low and strengthening forward-looking budgetary planning. Moreover, once the crisis occurred and financial markets were agitated by it, it became obvious that EMU did not have policy tools to manage and resolve the crisis. In the end, the European Union responded to the crisis first by agreeing on stabilisation for Greece and then by creating the European Financial Stability Facility (EFSF) that succeeded in calming the markets. However, these responses were developed in an ad-hoc manner and on a temporary basis only and do not provide a sufficient basis for dealing with any possible future debt crises in the euro area.

Several proposals have been put forward for how to improve the euro area's capacity to deal with problems of excessive public debts. In order to prevent sovereign crises, the European Commission (2010) has proposed a number of measures to strengthen the Excessive Deficit Procedure and the Stability and Growth Pact. These proposals focus mainly on making the rules of the current framework more effective and on strengthening their enforcement by introducing stiffer and more automatic penalties for violating these rules. The European Central Bank (ECB) has made proposals (2010) going in the same direction and, at the same time, has called for the creation of a crisis management fund for the euro area, which would come into play if the strengthening of the rules-based framework does not suffice to prevent future debt crises. According to the ECB's proposal, such a fund should provide 'last-resort financing' at penalty rates to governments facing difficulties in accessing private credit markets.

It is, however, the German government that has most forcefully argued for the creation of an orderly default mechanism for euro-area member states, partly as a condition for making the EFSF permanent. Following a French-German agreement on 18 October to create a 'permanent and robust framework to ensure orderly crisis management in the future', the European Council of 28-29 October 2010 stated that 'Heads of State or Government agree on the need for Member States to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole and invite the President of the European Council to undertake consultations with the members of the European Council on a limited treaty change required to that effect' (European Council, 2010). There are also reports that the German finance ministry is preparing a proposal for coordinating the demands of bond holders in a sovereign debt crisis and imposing 'haircuts' on the face value of the debt of a government in financial distress.

Outside official circles, there have been several plans along similar lines, most notably by Gros and Mayer (2010) who proposed the creation of a European Monetary Fund aimed at both improving crisis prevention and financing a mechanism for sovereign debt resolution.

We agree that the euro area needs a mechanism for dealing with sovereign debt crises in an effective and predictable way. Even the most sophisticated and most effectively enforced set of fiscal rules will not eliminate the possibility of future debt crises in the euro area. One of the main problems of the crisis of 2010 was clearly that policymakers had no game plan for dealing with it. The absence of any rules guiding market expectations about how governments and the Commission would respond to the crisis contributed to the volatility of financial markets during the crisis and this, in turn, contributed to the sense of urgency policymakers felt about the need to act.

We propose in this paper the creation of a European Crisis Resolution Mechanism (ECRM) consisting of two pillars:

- A procedure to initiate and conduct negotiations between a sovereign debtor with unsustainable debt and its creditors leading to, and enforcing, an agreement on how to reduce the present value[1] of the debtor's future obligations in order to re-establish the sustainability of its public finances. This would require a special court to deal with such cases. The European Court of Justice is the natural institution for this purpose and a special chamber could be created within it for that purpose.

- Rules for the provision of financial assistance to euro-area countries as an element in resolving the crisis. Should a euro-area country be found insolvent, the provision of financial aid should be conditional on the achievement of an agreement between the debtor and the creditors reestablishing solvency. The task of supplying financial assistance could be given to the EFSF provided that it is made permanent and an institution of the European Union. Lending by the permanent EFSF could also be provided, under appropriate conditions, to euro area countries facing temporary liquidity problems, as currently foreseen by the temporary EFSF.

The ECRM would have to balance the interests of the debtor and its lenders and to keep moral hazard problems on both sides to a minimum. Thus, it must not be too lenient to governments in order not to create any incentive to borrow at unsustainable levels. Guaranteeing last-resort financing alone would not do that because the threat of imposing high penalty rates, which would lead to a further deterioration of the sustainability of public finances, is not credible in a crisis.

[1] This is usually called 'debt restructuring' as opposed to 'debt rescheduling' which consists of amending the timetable of repayments without changing their present value.

The ECRM must also not be too lenient to private creditors, as the current response to the crisis has been, in order not to create incentives to lend to governments without careful regard to the state of their public finances. In fact, one of the main benefits of creating an ECRM would be the public acknowledgement that the default of a government on its debt is a real possibility in the euro area. This, along with necessary changes in financial regulation and supervision, would prompt creditors to differentiate among sovereign debt issuers, thereby strengthening market discipline and helping prevent further debt crises. At the same time, however, the ECRM must help both the debtor and its creditors to recognise when debt is unsustainable and to prevent financial market turmoil and costly delay in restructuring.

The creation of the ECRM would likely need to be established by a treaty. The mechanism would, therefore, only apply to future debt issuance.

2 Why the euro area needs a mechanism for sovereign-debt default

Sovereign defaults have been a fact of life throughout history. Sturzenegger and Zettelmeyer (2006) show that, among the member states of the euro area, Austria, Greece, Germany, Italy, Portugal and Spain have each experienced at least one case of sovereign default since 1824. Most of these defaults occurred during the Gold Standard. This is significant, because the Gold Standard, like membership of the euro area, implied that a national government could not revert to high inflation to rid itself of an excessive debt burden except by leaving the Gold Standard, at least temporarily. Germany alone has defaulted on its sovereign debt three times in the past 100 years (Kratzmann, 1982; Waldhoff, 2004). Thus, even if the possibility of sovereign defaults is generally not provided for in national legal frameworks for default and insolvency, it cannot be denied (Hattenhauer, 2000).[2]

In a monetary union, sovereign default is an even more relevant issue than in a monetary regime of national currencies because member states' lack of monetary policy autonomy. This situation was recognised in the early discussions on EMU and provides the essential rationale for the prohibition of co-responsibility for public debt (Article 125 of the treaty) and the prevention of excessive deficits (Article 126, upon which the Stability and Growth Pact is based). The greater possibility of sovereign default in a monetary union is just the dark side of the well-known argument that highly indebted countries benefit from euro-area membership in terms of lower interest rates paid on their public debt because the monetary union makes the commitment to low inflation more credible. By closing the inflation channel, monetary union leaves a country with only three ways out of a situation of excessive debt: severe and harmful fiscal retrenchment, default, and being bailed out by the other members of the monetary union. The bail-outs of the German states of Bremen and Saarland by the Federal Republic of Germany in the early 1990s are recent examples of the latter option. Furthermore, countries with excessive public-debt ratios may also suffer from an overvalued real exchange rate vis-à-vis the euro partners. This is likely to make restoring price competitiveness and reducing the debt burden two conflicting objectives.

From an economics perspective, there is no reason to believe that a debt crisis or the default of an individual euro-area member state on its public debt would put the price stability of the euro at risk. The euro's internal price stability is not threatened because, as long as the ECB does not monetise public debt and deficits directly, a government's access to private credit has no implications for the money supply and, hence, for inflation in the euro area.[3]

[2] Germany's Constitutional Court has explicitly recognised the state's right to free itself from an excessive debt burden by means of declaring bankruptcy (Waldhoff, 2004).

[3] Proponents of the fiscal theory of the price level argue that inflation is driven by the growth of the public sector's total nominal liabilities, not just money. If so, a sovereign default would alleviate inflationary pressures.

By the same token it could be argued that the euro's external stability would not be threatened by the default of one of the participating countries. No one worried about the stability of the US dollar when the City of New York filed for bankruptcy in 1975, nor when Orange County did so in the early 1990s, and no one seems worried about the stability of the US dollar despite the current fiscal crisis of California, although California is a significant part of the US economy. As discussed in section 4, however, the default of a medium-sized member would be a more significant financial event for the euro area in view of the debt levels and the concentration of holdings in the euro area. Financial stability concerns would be likely to enter into play.

It is true, however, that the 2010 euro-area sovereign-debt crisis created much volatility in euro financial markets, causing large movements in bond yields and in the euro's exchange rate with other currencies. This volatility was the result of the markets' uncertainty about whether or not the other euro-area member states and perhaps the ECB were willing to help the Greek government financially and, if not, what would happen in the case of a Greek default on the country's sovereign debt. At some stage markets even seemed to fear that, if not properly handled, the Greek crisis could ultimately lead to the demise of the euro.

From the point of view of individual bond holders, there are three relevant sources of uncertainty associated with sovereign-debt problems, two that are general and one which is specific to the euro area:

- Uncertainty about the willingness and ability of a distressed government to honour its financial liabilities;
- Uncertainty about the behaviour of other bond holders; and
- Uncertainty about the extent of financial assistance from other euro-area member states, the EU as a whole, and the ECB.

The first type of uncertainty is embedded in all borrower-lender relationships. In the case of public debt it is aggravated by the fact that the main asset of a sovereign debtor is its power and capacity to tax, which is intangible in nature (Hattenhauer, 2000). The economic value of this asset depends on the degree of hardship a country's citizens are willing to bear in order to service its debt and on the government's administrative capacity to raise revenues (ie on the primary surpluses the government is able to achieve) and is, therefore, largely an issue of political judgment. The uncertainty surrounding it implies that market expectations can change drastically with the arrival of even small amounts of new information. Looming behind this uncertainty is the classic borrower-lender moral-hazard problem: an organised bankruptcy offers the possibility for a government to free itself from a large debt burden by defaulting on its domestic and/or foreign debt. This may be more attractive than servicing the debt, a possibility foreseen already by Adam Smith (Waldhoff, 2004; Kratzmann, 1982).[4]

The second type of uncertainty relates to two classic coordination problems among creditors in the case of a default. The first one occurs *ex ante*, ie before a sovereign default (or bail-out) has been declared, and consists of the risk of a 'creditor grab race', in which individual creditors rush to sell off their bonds or refuse early to roll over a given stock of debt, leading to a decline in bond prices, and causing other creditors to behave in the same way (Thomas, 2004). If declining bond prices make potential lenders shy away from the market and refuse to roll over a country's debt, this may aggravate a financial problem to the point of triggering a crisis that might otherwise have been avoided.

The other coordination problem is the *ex-post* risk of a 'hold-out', in which a minority of the bondholders - including possibly a 'vulture fund' having bought some of the distressed debt at low prices - refuses to agree to the restructuring of a country's debt in the hope of being bought out in full by the majority. Assume that a highly indebted country needs a cut in its debt burden by, say, 30 percent in order to secure servicing of the remaining debt, and that a majority of the creditors agrees that this is better than losing all their money. A minority-group of creditors might then ask the rest - possibly with the help of a court - to pay them out in full in order to agree to the settlement. Rogue or vulture creditors of this type may prevent a settlement that is in the collective interest of the creditors in order to maximise their joint payoff.

The third type of uncertainty is specific to European Monetary Union and results from the tension between the principle of solidarity that binds the union members together on the one hand and the principle that each member, as a sovereign state, is responsible for its own finances on the other. Before the recent crisis, the common reading of Article 125 of the treaty was that it ruled out the possibility of a bail-out of an EU member state by other member states or by the European Union, hence its alias: 'no-bail-out clause'. Without the strong affirmation of this principle, it would have been hard, if not impossible, to persuade Germany to join the euro area. [5,6]

During the 2010 sovereign debt crisis, public statements by leading policymakers in the euro area and the EU Commission affirmed the principle of solidarity and the possibility of helping

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[4] As Rogoff (1999) notes, it is not easy to answer the question why sovereign debtors ever repay their debts.

[5] See eg the 1993 ruling of the German Constitutional Court on the Maastricht Treaty, which argued that monetary union was based on the concept of a union of stability. Should this stability not be maintained, the monetary union would no longer remain within the bounds of its treaty base.

[6] There is, however, some disagreement concerning the precise meaning of Article 125. The term 'bail-out' as such is not used in the treaty. What the treaty says is that no country or EU entity can assume responsibility for a member country's public debt. This no-co-responsibility principle is arguably different from a no-assistance principle (Marzinotto, Pisani-Ferry and Sapir, 2010) and this is the reason why it is claimed that assistance to Greece could be provided without being at odds with the treaty.

Greece or other distressed governments solve their debt problems. In the absence of any rules or procedures other than ‘no bail-out’ and without any clear vision of what a sovereign default would look like and what its effects on the euro would be, policymakers first procrastinated for months, with some insisting on the principle of no bail-out, and others affirming solidarity. This left markets guessing whether or not the EU as a whole, the euro-area member states, or the ECB would provide financial support to distressed governments. Again, any small piece of news was enough to move interest rates and exchange rates. In the end, the governments reverted to emergency packages that were put together in a hurry and left many questions open. The risk of collapse of the euro and the associated sense of urgency proves that a no-bail-out clause with no rules for how a default of a euro-area member state would evolve is not credible because, when crisis strikes, governments look for options to prevent a default. To simply refuse to assist Greece would not have been credible anyway since the country was still a member of the IMF and as such was entitled to receive international assistance with or without European assistance.

A sovereign-debt restructuring mechanism seeks as far as possible to avoid the second and third types of uncertainty while minimising the first type of uncertainty and the attendant moral hazard problem for the debtor governments. Sovereign-debt resolution involves a combination of fiscal adjustments by the defaulting government on the one hand and, on the other, cutting the amount of debt outstanding, prolonging the maturity of the remaining debt and reducing the interest paid on it. Its main purpose is to return the debtor-country back to a state of sustainable public finances. At the same time, it aims at a fair distribution of the cost of restructuring between the borrower and the creditors.

To avoid market turmoil, a debt-restructuring mechanism must guide market expectations effectively about the steps that will be taken in the resolution of a debt crisis and their likely outcomes. At the same time, it must provide policymakers with a game plan for such situations and, in the case of EMU countries, resolve the credibility problem of the unconditional no-bail-out clause. This latter aspect is new in international monetary and financial relations, though not in the context of federal states. Furthermore, the mechanism must set clear rules for involving the creditors in the crisis resolution, which would give creditors stronger incentives to care about the credit worthiness of sovereign debtors *ex ante* and thereby strengthen market discipline.

In past international sovereign-debt crises, resolutions were managed by the Paris Club and the London Club. The Paris Club brings together defaulting sovereign debtors and their sovereign lenders to negotiate a solution, while the London Club brings together defaulting sovereign debtors and their international bankers. Neither of these institutions is suited to sovereign-debt problems in the euro area, since most of the outstanding public debt in the euro area is in the form of government bonds rather than bank loans or intergovernmental credit. Hence a new institutional solution has to be found.

It is sometimes argued that contingency planning is unnecessary, if not harmful, and that a pragmatic solution will be found if and when the problem arises. The lessons from the 2010 crisis, however, are that it can take a long time to reach an agreement and that delays involve costs: while policymakers negotiate, markets speculate about the probability, nature and depth of a compromise. To rely once again on improvisation to find a solution would involve significant risks for the stability of the euro area. Furthermore, the question raises fundamental issues about the principles that underpin Economic and Monetary Union, on which ambiguity should not be allowed to prevail.

Currently, only the US has a formal, explicit bankruptcy procedure for government entities - Chapter 9 of the US Bankruptcy Code - which applies to municipalities.[7] Chapter 9 was created during the Great Depression, when a number of local governments were unable to service their debts. However the US has no formal procedure for default by states. [8,9]

Earlier in this decade, the IMF presented a proposal for a Sovereign Debt Restructuring Mechanism (Krueger, 2002; Rogoff and Zettelmeyer, 2002a, b) to deal with defaults of developing and emerging market countries, which is discussed in detail in the next section.

[7] For an overview of Chapter 9 and its main properties, see Raffer (1990).

[8] The reason why there is no formal procedure in the US for state default is that states have 'sovereign immunity', which means that they cannot be sued. This does not imply, however, that states cannot be in a position where they are unable to service their debts. This would happen if a state were unable to borrow. In such an event, the federal government would step in and put the state in question into receivership, a situation which has never occurred in the history of the US, partly because most states have statutory balanced budget requirements.

[9] Germany has an implicit procedure for debt crises of individual states resulting from the rulings of the constitutional court in the cases of Saarland, Bremen and Berlin. Accordingly, a state has a right to the solidarity of the federation if it finds itself in a situation of budgetary emergency. In its Berlin ruling, the court made it clear that, as long as a state has sizeable marketable assets (such as public housing), such a situation does not exist.

3 - Past attempts to create a sovereign-debt restructuring mechanism

After the Mexican crisis of 1994-5, the attention of the international community turned to the problem of unsustainable sovereign debt.[10] At that time, the Mexican assistance package was the largest in history, and was supported with resources from the IMF and from the US[11]. The policy and academic communities reacted to the magnitude of support needed, and discussions and proposals were put forth to try to avoid the need for a similar bail-out in the future.[12]

Until the l980s, most sovereign debt had been owed either to official lenders (in which case the Paris Club could deal with it) or to private banks (of which a relatively small number held a large fraction of the debt). In the Mexican crisis of 1994, by contrast, much of the sovereign debt had been issued in the form of bonds (especially the dollar-indexed tesobonos, ie short-term government obligations whose value in pesos was linked to the US dollar). After much discussion, in 1996, the official sector through the G10 issued a report (Rey, 1996) recommending that Collective Action Clauses (CACs) be inserted in sovereign-debt bonds to facilitate sovereign-debt restructuring when necessary. CACs, it was argued, would enable bond holders of a given class to vote and to accept a restructuring offer if at least a specified percentage were in favour. An affirmative vote at or above the specified level would then bind all other holders of that class of bonds to accept the offer.[13]

There was also, in the mid 1990s, a discussion of 'private sector involvement' (PSI). Many raised questions as to why the official sector should be largely, or solely, responsible for 'bailing out' sovereign borrowers. Instead, it was argued that private creditors had to be 'bailed in'. PSI was the official response and was incorporated into IMF policy, to the effect that, in the event of crises in which official (especially IMF) money was used, private lenders should contribute to (be 'involved in') crisis resolution. In the event, it proved difficult to achieve meaningful private-sector involvement. When IMF lending was directed to financial support in an effort to head off a crisis (by providing enough support so that private lenders would be reassured and be willing to roll over loans and perhaps provide new money), the very fear that the official sector would attempt to require private lenders to roll over debt and/or extend additional credits was likely to drive private lenders to reduce or eliminate

[10] In the early 1980s, a large number of sovereign debtors encountered debt servicing difficulties after they had borrowed in the 1970s (to finance current-account deficits after the oil price increases) and then were confronted with large increases in interest rates on their debt. That debt was mostly to banks and the issue was not resolved until the Brady Plan, enabling restructuring of debt, was put forward in the late 1980s. Growth was very slow, if positive at all, until debt was restructured.

[11] The IMF portion was $30 billion and the US commitment was $20 billion. The US portion was never drawn.

[12] There was much literature on the subject during that period. For a review, see Rogoff and Zettelmeyer (2002b). For a later survey, focusing primarily on the empirical literature since the Argentine debt crisis, see Panizza, Sturzenegger and Zettelmeyer (2009).

[13] Embodying procedures to deal with insolvency in debt contracts is referred to as the 'contractual' approach, and is distinguished from the 'statutory' approach, in which procedures spelled out in domestic or international law would be followed and bind the parties.

their exposure before such a requirement was set. It would simultaneously precipitate the very phenomenon the IMF was trying to help the debtor to avoid. PSI did not, therefore, prove very useful as a tool of crisis avoidance or resolution.

Resistance and objections to CACs were raised in many quarters. The private financial community in particular vehemently rejected the proposal. No action was taken and the issue was therefore dropped.

The Russian and Asian crises of 1997-98 were primarily the result of private, rather than sovereign, debt, and the problem of how to handle sovereign-debt crises did not appear central to the issues raised by those crises. Thus, as of 2000, the international community's tools for addressing sovereign debt were effectively little changed from what they had been twenty years earlier, despite the fact that a much greater share of sovereign debt was in the form of bonds and that, on average, these debts had risen considerably as a percent of GDP in the borrowing countries.

As already discussed in section 2, one of the earlier concerns about sovereign debt had been the 'market failure' that resulted when creditors began to doubt the ability of the sovereign to sustain debt-servicing commitments. Whichever creditors were able to get out first would generally experience smaller, or even no, losses compared to the losses that would be incurred by those who continued holding their debt instruments and were more loyal to the sovereign: the result could be a self-fulfilling panic and a rush to the exit. Since this could involve unwillingness to roll over existing debt, as well as to extend any new credits, it would bring about a crisis even if the longer-term outlook was not so unfavourable. Moreover, as sovereign debt spreads would rise in the secondary market, there was a risk that vultures would buy up some of the distressed debt at very low prices, but then hold out for full repayment and refuse to agree to a restructuring. This, in turn, could discourage the sovereign from seeking to restructure debt, and leave other creditors reluctant to agree to a restructuring if the existence of hold-outs were suspected or known.

A rogue creditor (Elliot Associates) in fact succeeded, in 1996, in buying Peruvian debt at a heavy discount prior to a Peruvian restructuring and in receiving full face value, as the Peruvian government was willing to compensate the hold-out in order to complete the restructuring effort.

The Peruvian case led to a resumption of interest in problems associated with sovereign debt, and in what should be done in case of crisis. Almost all agreed that the existing state of affairs was unsatisfactory, and that some form of framework for sovereign-debt restructuring was warranted when sovereign debt was truly unsustainable.

But the motivation for seeking a framework to avoid vulture funds was different from the motivation of those seeking PSI. The latter group (in which European voices were prominent) sought to reduce the financial burden on the official sector when sovereign debt crises arose, and to reduce the magnitude of IMF lending needed. The former wanted to prevent vultures from profiting so much and delaying restructuring efforts.

Yet a third motivation for supporting an SDRM lay in the view that uncertainties regarding the likely behaviour of creditors during the period of restructuring would deter the sovereign from seeking it. This, in turn, would make the costs of truly unsustainable debt needlessly higher than they had to be. Opponents of the SDRM, however, especially in the private sector, argued that there should be no reduction in costs of default or restructuring. Proponents of SDRM countered that the delays prior to facing the inevitable were very costly, and that there was more on the table for creditors and debtors when necessary restructurings were undertaken promptly and in an orderly fashion.[14]

It was evident to all that there could be instances in which sovereign debt was unsustainable. Some thought the contractual approach, of which CACs were one possibility, held sufficient promise. Others sought an international mechanism (there had been earlier proposals) to resolve unsustainable debts, along the lines of a bankruptcy mechanism in domestic law.

The IMF's SDRM proposal

The proposal was first put forth in 2001, and evolved in response to reactions and discussions.[15] The proposal always envisaged that the SDRM would be treaty-based, so that all IMF members would adhere to its provisions.

Initially, it was proposed that the IMF would need to approve the activation of the mechanism, but this provision was later omitted in response to concerns that the IMF would have too much power.[16] The mechanism would put a stay on creditors' claims, thus preventing vultures or others from pursuing legal action and posing an obstacle to restructuring.

In addition to the binding of all IMF members to the legal provisions of the mechanism, the chief difference with the collective action clauses (CAC) proposals was and is that the SDRM would have enabled aggregation across all creditors' claims, in contrast with CACs which

[14] The Argentine situation was headline news during the period in which the SDRM proposal was being discussed. In that situation, real GDP had been falling every year after 1996, and by the beginning of 2001 it seemed evident to all that restructuring would have to occur. Whether the existence of an SDRM would have led the authorities to act more quickly is, of course, a hypothetical question.

[15] The final proposal was tabled at the IMF (2003).

[16] The rationale for proposing the need for IMF approval was the concern that the mechanism might be activated by a debtor whose debt was sustainable. After discussion, however, it was concluded that there were sufficient disincentives to do this so that IMF approval would not be needed. A concern throughout the discussions, however, was that the design of the mechanism should not enable debtors to obtain additional leverage in debt restructuring negotiations but rather that such negotiations could be undertaken more promptly and in a more orderly fashion.

apply only to individual bond classes.[17] This would have prevented holders of an individual bond issue from blocking a settlement (and avoided any risk that a creditor might acquire enough of an asset class to block a restructuring).[18] Creditors' agreement on restructurings would then have been based on a vote for approval by a specified percentage of all creditors, and would not require the specified majority in each individual class.

There were other significant differences with CACs. The debtor would have been required to provide detailed information as to its indebtedness and its intentions as to how to address it. Negotiations would have been undertaken through a representative creditors committee.

It was envisaged that the IMF would continue to play its role in provision of short-term financial support for debtor countries when that support would enable more rapid recovery for the debtor and thereby provide a promise of a larger primary surplus and ability to pay. The Fund's concern with 'lending into arrears' only when it was determined that the country was making good-faith efforts to restructure was to continue.

The SDRM was proposed as a mechanism that would provide greater predictability and timeliness to restructuring of truly unsustainable debt than would otherwise have been possible. It was anticipated that this predictability and timeliness, in turn, would enable debtors and creditors more easily to restructure 'in the shadow of the law', as happens in some domestic bankruptcies, and simultaneously speed up the debtor's recognition of the need for action and hence the restructuring process when debt was truly unsustainable, without changing the balance of leverage between creditors and debtors.

<u>The debate on the SDRM proposal</u>

In the case of the IMF's SDRM proposal, the differing concerns of creditors and debtors were a major basis for disagreement and dissent, but there were also elements of misinformation.

Turning first to different interests, the private financial community (obviously a creditor) was firmly opposed to an SDRM (as it had been to the CAC proposal in 1996), believing that such a mechanism would overly strengthen debtor rights.[19]

Throughout the debate about the SDRM much was made, both by some creditor governments and by the private financial community, of the argument that an SDRM mechanism would give too much power to the IMF and would put it in a conflict-of-interest

[17] Disputes inevitably arise between creditors and debtors as to the validity and the aggregation of claims. Sorting these out is a technical matter, and it was proposed that there be a Dispute Resolution Forum whose members would have expertise in the area, and who would resolve such disputes. This was not controversial.

[18] Aggregation across asset classes must happen in all restructurings: liabilities of different maturities must be accelerated and appropriately weighted. But an SDRM could have provided principles and rules for such aggregation, thereby reducing uncertainty for creditors and debtors alike.

[19] If a sovereign with unsustainable debt could achieve debt restructuring, an important question would be the percentage of the 'haircut' (ie the reduction in the face value of the debt) that would be permitted. Creditors clearly feared that an SDRM would reduce IMF lending to an extent that their payback would be smaller.

position, as it is itself a (privileged) creditor. This particular line of attack failed to recognise the tight link (despite inevitable uncertainty) between IMF 'conditionality' and the future path of the primary surplus. Lowering projected fiscal deficits and undertaking policy reforms that could raise prospective growth rates would enable smaller haircuts during restructuring than would be necessary in the absence of those measures.

The IMF in fact altered its proposal to reduce its power in any restructuring. But it remained incontrovertible that IMF resources would in almost all cases be needed in the short run and that IMF conditionality would be important in determining the future trajectory of the primary surplus.

There was also ambivalence among countries that were prospective borrowers from the IMF. Many recognised that an SDRM could reduce the costs of a sovereign-debt crisis, should one arise, but at the same time feared that IMF financing to avoid such an outcome would be less likely.

The European desire for bail-outs of smaller magnitude gave some credence to those concerned with the future size of IMF lending in crisis situations, but ignored the central role of debt unsustainability in bringing about crises, when additional lending to the country would not help (except insofar as interest paid on loans was lowered). But, equally, it was highly unrealistic to think that an SDRM mechanism would obviate the need for Fund resources.

Beyond these general concerns, four arguments played important roles in the discussion. First, uncertainty about how much of a haircut would be agreed, and how it would be decided, was certainly a major factor leading to resistance and opposition to the proposal. It is arguable, however, that this uncertainty was always present until the size of the future primary surpluses was determined. In fact, as already seen, if a sovereign held unsustainable debt, the sustainable level of debt would of necessity be determined by the net present value of the primary surpluses the sovereign would incur in the future.[20]

The second argument used against the SDRM proposal was that private markets could, of themselves, resolve debt issues, and that an SDRM mechanism was not 'market-friendly'. The reasoning behind this assertion was not spelled out. The counterargument, that bankruptcy mechanisms are essential parts of commercial codes if private markets are to function reasonably efficiently, was not addressed. The débâcle of Argentina's delayed and

[20] The primary surplus is the value of resources (normally expressed as a percentage of GDP) left over in the sovereign's budget for servicing principal and interest on the debt. Clearly, the sustainable level of debt is equal to the discounted value (the present value) of these future payments. The role of the IMF was always to work with the authorities on budgets in order to programme a feasible primary surplus.

confused debt restructuring certainly provided at least one important instance in which the private market was not at all effective in handling a debt restructuring.[21]

To the argument that the private market could handle restructuring, proponents of the SDRM answered that there was nothing in the SDRM proposal that would prevent that from continuing to happen. Indeed, restructuring could always take place between creditors and debtors and, just like a good bankruptcy mechanism, such an outcome could occur 'in the shadow of the law' without recourse to a legal process.

Third, the argument was made that the presence of the SDRM mechanism would induce sovereigns to seek to restructure debt rather than trying to repay it, thus increasing the likelihood of default. This seemed to be a view held in some, if not most, parts of the financial community. To this, proponents of the SDRM had two counterarguments. They responded that creditors would in fact receive more if restructuring - when necessary - could be undertaken sooner, as the losses incurred during the run-up to the inevitable restructuring would be smaller. They also insisted that the pain of restructuring was sufficiently great so that sovereigns would not willingly undertake it unless debt was truly unsustainable: the problem was that sovereigns waited far too long, not that they eagerly defaulted on their debts.

The fourth and final argument, which was based neither on differing interests of creditor and debtor nor on misinformation, was the proposition that CACs could improve the international mechanism for restructuring sufficiently so that the SDRM was unnecessary. A variant of this argument was that the SDRM was infeasible politically and that therefore CACs would have to do.

To that argument, proponents of the SDRM pointed out that CACs in essence bound creditors of any given asset (say, a particular bond issue) if the requisite majority voted in favour of accepting a debtor's restructuring proposal, but did not bind across asset classes. Since there are invariably conflicts of interest between different classes (longer maturity holders want immediate acceleration of their issues, while those holding short-term debt do not; some are concerned with maintaining the face value of the principal while others would prefer to accept a reduction in face value and maintain a higher interest rate…), aggregation across classes can be a major difficulty.

Why the proposal failed

[21] In the SDRM debate, it was generally assumed that no sovereign would seek to restructure its debt unless debt is truly unsustainable. The restructuring by Ecuador in 2006, when debt was clearly sustainable, has called into question that assumption. See International Financial Law Review, September 2009, 'Ecuador's sovereign bond default'.

The SDRM proposal received enthusiastic support from many quarters: the vast majority of the votes of the IMF Board of Governors supported the proposal.[22] It was always recognised, however, that for the SDRM to become effective, it would require not only passage by the Board of Governors (by 85 percent of the total voting power or more) but also an amendment to the IMF's Articles of Agreement.[23] Some proponents failed to support the proposal enthusiastically in part because they believed that the proposal could never be passed by the requisite majority.

In addition to doubts about feasibility, the issues raised above certainly reduced enthusiasm. Misinformation (such as the failure to recognise the rigid link between fiscal and other reforms, the future primary surplus, and debt sustainability), concerns on the part of some developing countries that they might in future be refused sufficient IMF support and would have to restructure, belief that spreads might rise, and other factors all contributed to doubts about the proposal.

But the fact that the US effectively held veto power doomed the SDRM proposal once the US administration formally opposed it.[24]

As an alternative to the SDRM, the US authorities had supported the incorporation of CACs into bond covenants, and believed that they would be sufficient to address the issues the SDRM proposal sought to fix. Why the existence of CACs in individual bond issues would induce sovereigns to reduce delays before confronting their unsustainable debts was not explained.

Lessons for the euro area

The conflicts between interests of creditor and debtor countries are likely to arise in the euro area as they arose in the SDRM discussion. At their heart will certainly lie the issue of how much say creditors have over the future course of the primary surplus (and therefore

[22] Some opponents have argued that some, if not much, of that support was disingenuous in that it was always known that the United States would veto the proposal, and had the votes to do so. That the SDRM issue was raised repeatedly after the US rejection suggests, however, that much of the support was genuine.

[23] The desirability of an amendment was based on keenness to have international law govern all countries' issuance and ownership of sovereign debt instruments.

[24] President Bush's first Secretary of the Treasury Paul O'Neill supported the proposal, although it was soon recognised that the rest of the administration, and even other officials in the Treasury, were not supportive. It is unclear whether subsequent opposition to the SDRM was in response to the vehement objections of the private financial community or more based on the 'market-unfriendly' set of arguments. Probably both of those, plus the lack of any strong supporters within the administration once O'Neill left, were significant contributing factors.

the degree of austerity in the initial years after restructuring). Agreeing on an appropriate mechanism for determining the 'reasonable' degree of adjustment relative to the necessary amount of restructuring as well as the magnitude and timing of financial assistance will be critical. What this consideration does imply for the euro area is that the procedures agreed upon for a European mechanism would need to include measures to insure the impartiality between creditors and debtors of the debt restructuring process.

A second lesson, with hindsight, is that proponents of the SDRM assumed its benefits but were not sufficiently persuasive in the argument that there was money on the table for both creditors and debtors. In part, this was because the initial focus was more on the issues of market failures and vulture funds. But with hindsight it is clear that more effort should have been made to show the gains that might have been achieved with an SDRM mechanism. Persuading the policy community about the realities of over-indebtedness would be a crucial step in achieving an acceptable mechanism.

A third, and important, lesson is that many participants in the discussion did not recognise that unsustainable debt is unsustainable, and that when this is the case restructuring is inevitable: the only question was how long the authorities would struggle with a heavy debt burden (with falling real GDP and other attendant costs) prior to taking action.

4 A European mechanism for sovereign-debt restructuring

The previous sections argued that the euro area needs a mechanism for sovereign-debt resolution (section 2), and discussed efforts by the IMF to set up a global SDRM, which ended in failure (section 3). The relevant question now is whether the euro area can succeed where the IMF failed and manage to set up a regional SDRM. This question is really two-fold. First, one needs to examine whether a default could occur in the euro area, or whether it is a matter only for developing or emerging economies, as implicitly envisaged in the IMF proposal. Second, one must examine whether there are certain specificities in the European Union in general, and the euro area in particular, that may facilitate the creation of a regional, as opposed to a global, sovereign-debt resolution mechanism.

With respect to the first question, for the last 50 years or so all discussions on sovereign-debt resolution implicitly or explicitly assumed that it is a subject only for developing or emerging market countries. Yet, as the Greek crisis has amply demonstrated, it is a matter that now confronts the European Union, and more specifically the euro area, where inflation is no option for solving severe indebtedness (see section 1). Besides, some of the members of the euro area have development levels (measured in terms of GDP per capita or financial sophistication) that are comparable to those of countries that have defaulted in the past 50 years. Thus even assuming that only developing or emerging countries may resort to default (a questionable assumption), the euro area cannot consider itself naturally immune from risk.

With respect to the second question, there are two specificities that clearly set the euro area apart from other sets of countries. The first is that euro-area countries belong to the European Union, which is a community of law. In order to achieve economic integration, the EU members have agreed on a large degree of policy coordination and to cooperate through supranational institutions within a common legal framework. Participation in the EU entails the observance of the EU treaty and legislation, which has precedence over national law. Supranationality and partial loss of national sovereignty, the fears of which were a major reason for the rejection of the SDRM proposal, are therefore part and parcel of the existing EU. Within the union, monetary integration among the members of the euro area, which share a common currency issued by a common central bank, requires even closer cooperation, particularly with respect to fiscal policy coordination and discipline. Since a debt crisis in any country within the euro area risks undermining financial stability and thereby the common currency, an early and orderly resolution of the member's financial difficulties should therefore be of direct interest to other members of the area.

A second specificity arises from the very existence of the euro. As observed by Bini Smaghi (2010), debt in most emerging and developing country crises was usually essentially external and denominated in foreign currency (this is due to the inability of such countries to issue debt in their own currencies, as pointed out by Eichengreen, Hausmann and Panizza, 2003).

By contrast virtually all the public debt issued by euro-area countries is denominated in euro, and is mostly held by euro-area residents. Yet it is different from the domestic debt of countries owning their own currencies because more of it is held outside the issuing country and because the issuing country does not have full control over the currency in which the debt is denominated.

Official data are incomplete but existing estimates suggest that with the exception of German and French central government debt securities, of which about half is held by non-euro area residents, the bulk of euro-area public debt is held either within the issuing country or in other euro-area countries. For smaller euro-area countries holdings by other euro-area residents generally dwarfs domestic holdings. Financial integration within the euro area has therefore created a new situation where debt is both 'foreign' and 'domestic'.

Linked to this situation is the fact that, in recent years, defaulting countries have usually been relatively small (in terms of GDP, the largest were Russia in 1991 and Brazil in 1983, which accounted for about 2 percent of world GDP) and their debt ratios were relatively low, because of lower thresholds of debt tolerance of emerging market countries (see Reinhart, Rogoff and Savastano 2003). Even when their external debts reached fairly large levels in global terms (the largest was the Brazilian external debt in 1983 which amounted to about 0.9 percent of world GDP), emerging-market country defaults were relatively small financial events for individual creditor countries because their debt holdings tend to be geographically dispersed.

By contrast, euro-area countries are relatively large, and some of them have debts approaching or exceeding 100 percent of GDP and mostly foreign held. As a result the public debt of some euro-area countries is fairly high (around 4.2 percent of world GDP for Italy in 2009, and 1.3 percent for Spain), and mostly their holdings are concentrated among residents of few euro partner countries, making a default a potentially more disturbing event. The default of any euro-area country except the very small ones would thus be large enough to threaten the solvency of the partner countries' financial institutions, thereby causing governments to intervene to bail out creditor banks or insurance companies headquartered in their country. In other words, a poorly managed sovereign default of a euro-area country (or even the threat thereof, as was observed with the Greek crisis) could have resulted in a euro-area banking crisis, which would most likely have led to massive government support to prevent bank failure. One of the benefits of having a sovereign-debt resolution mechanism in place would precisely be to modify the behaviour of banks, and the financial sector in general, towards the holding of sovereign debt of dubious quality and therefore to limit the risk of bank failure and bail outs.

<u>Elements of a sovereign-debt restructuring mechanism for the euro area</u>

As already indicated, sovereign defaults are different from private defaults in a number of ways. The first is that, in contrast to a private company, the sovereign entity cannot be dissolved, a forced liquidation of its assets is impossible, and its creditors cannot assume ownership. Since the economic value of a sovereign's main asset is uncertain, the declaration of bankruptcy in the classic sense - where the total liabilities exceed total assets - is impossible. This implies that a debt restructuring procedure, if it exists, can only be invoked when the sovereign debtor declares itself unable to pay its debt service (Kratzmann, 1982).

Second, while a private bankruptcy procedure primarily aims at maximising the value the creditors can extract from the defaulting institution, a defaulting sovereign must be left with the financial means to perform at least minimal functions of government. This implies that 'bankruptcy' and 'insolvency' are misnomers for a procedure addressing sovereign-debt crises. The only sensible goal of the procedure should be to restore the sustainability of the sovereign's public finances, which is in the interest not only of the debtor but also its creditors.

Third, under democratic government or a community of democratic states, it is inconceivable that a government be put under receivership, because this would contradict the nature of democracy. As argued above, the economic value of the government's power to tax depends on the quality of administration and the loyalty of the citizens. Hence, imposing administrative oversight or heavy direct intervention into public affairs from the outside, while it might limit the national administration's ability to misrepresent tax revenues, could also destroy the value of the asset, as the national administration might be unwilling to cooperate and citizens might increasingly resist taxation.

These differences imply that the instruments to deal with sovereign-debt crises in an orderly way are more limited than in the case of private debt, where the ultimate solution remains liquidating the borrower's assets and, in the case of corporations, dissolving the organisation. In the case of sovereign debt, a procedure must be found to restructure the debt in an orderly fashion through negotiations with the creditors. For the euro area, such a framework would have to have four main elements:

- First, a formal way to initiate the debt-resolution procedure. Rules should be conducive to relatively early engagement of creditors and debtors in an exchange of information and views on the current situation in order to reduce the uncertainty of the creditors (Krueger, 2002). Given the potentially large number of creditors/bondholders, the initiative to start the procedure should come from the debtor government. With the opening of the procedure, the country would immediately stop servicing its debt to national and international creditors and there would be a stay on all litigation by individual creditors seeking repayment.

- Second, a mechanism to prevent a minority of bondholders from exploiting the majority by refusing to agree to a restructuring of the debt in the hope that the majority would buy them out. This requires that a super-majority of bondholders (say, two thirds) can outvote the minority in the decision to enter into negotiations and to conclude agreement with the debtor country regarding a restructuring of its debt. Furthermore, it requires that a stay can be imposed on all litigation against the debtor country to enforce the repayment of any parts of the debt to groups of creditors.

- Third, a mechanism to conduct negotiations. In civil bankruptcy procedures, this is the role of the court-appointed trustee. In the context of sovereign default, the sheer size of the task implies that it would have to be assumed by a neutral, politically independent body.

- Fourth, a rule for the provision of fresh credit from the EU or other euro-area member states to the government in financial distress. In the past, sovereign defaults have often been accompanied by periods during which the defaulting government no longer had access to credit markets. To help the government concerned over such a period would be a reasonable thing to do for the EU provided that a restructuring of the country's debt has occurred. This approach would prepare the way for a combination of debt restructuring and debt crisis management as recently proposed by the ECB (2010).[25] In fact, if economic solidarity is a mark of European Union, this combination would be a good way to combine solidarity with sound economics.

Our proposal

There are two approaches to the design of sovereign-debt restructuring procedures that are potentially consistent with the four elements just outlined. One is the 'contractual' approach which would encourage the inclusion of collective-action clauses (CACs) in sovereign-bond contracts. The other is the 'statutory' approach along the lines of the IMF's SDRM proposal.

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[25] The ECB (2010) proposes a lender-of-last resort mechanism to support euro area member states in situations where they do not obtain access to private credit. However, the ECB does not provide much detail about this proposal. It would build on the EFSF and act as a lender of last resort for public borrowers. The ECB explicitly excludes the use of any funds coming from this agency to bail out private creditors. Bail-outs of euro-area countries should not be linked to an expulsion from the monetary union, because this would undermine the credibility of the common currency. Conditions for financial support should come at penalty rates. The ECB proposes to make financial support very unattractive for the recipient government and to extend it only under preferred creditor status and based on good collateral. Adopting a mechanism of this kind would amount to implementing a permanent bail-out framework. Markets could always anticipate that governments in financial distress receive assistance from the EU. Thus, the kind of market volatility observed in the first half of 2010 would not arise. Note, however, that the ECB's request for preferred creditor status for the bail-out fund would be counterproductive, because private creditors would still face the possibility of losing their money. It would leave banks and investment funds with no guidance for their expectations regarding the solution of a fiscal crisis.

The contractual approach has obvious advantages. It does not involve supranational decisions and leaves negotiation on the terms of the agreement to the parties involved. It only requires, as a way to overcome the collective-action problem, a joint commitment to include CACs in bond issues, presumably at no visible cost. And it does not involve any detailed legislative work.

Our view is, however, that the contractual approach is at least insufficient and perhaps even unsuited to the European case because it is intended to facilitate the negotiation of a settlement between a country and its private creditors whereas, as already discussed, the default of a euro-area country might raise concerns over financial stability in the euro area as a whole. This would necessarily lead the governments of the affected countries to step in, thereby transforming the negotiation between a country and its private creditors into a *de-facto* international negotiation involving states. In addition, the contractual approach has the disadvantage that it pertains only to individual bond classes.

We therefore advocate the statutory approach, which allows aggregation across all creditors' claims, and propose the creation of a European Crisis Resolution Mechanism (ECRM). While the creation of the IMF's SDRM was rejected on the grounds that it would interfere with national sovereignty, this objection is much less valid at European level where states have agreed to share sovereignty within the framework of the EU's community of law.

In order to fulfil its main objective, which must be to seek a restructuring of the debt outstanding that restores the sustainability of the sovereign debtor - thereby making both private creditors and the sovereign debtor better off than in its absence - the design of the ECRM should be guided by a set of general principles consistent with the four principles outlined above:[26]

- The mechanism should only be used to restructure sovereign debt that is deemed to be truly unsustainable. When the debt of a country has been judged as unsustainable, the mechanism should create incentives for an early and collaborative resolution between debtor and creditors.
- The mechanism should not interfere with the sovereignty of debtors. Its activation could only take place at the request of the sovereign debtor.
- The mechanism should provide a framework establishing incentives for a negotiation between the debtor and its private creditors. In keeping with established procedures, claims of official bilateral creditors would be excluded from the mechanism and be subject to Paris Club restructuring; those of multilateral creditors would be excluded altogether from sovereign restructuring.[27]

[26] These principles are broadly similar to those envisaged for the IMF's SDRM. See IMF (2002).

[27] During the SDRM episode there was a discussion about whether the mechanism should apply not only to private but also to state creditors. The latter, however, strongly opposed such a possibility, preferring instead to retain their privileged treatment under the Paris Club.

- The mechanism would allow a sovereign debtor to reach an agreement with all the creditors that are subject to the restructuring by making a settlement offer which, if approved by a qualified majority of all these creditors, would be binding on them all. The threshold for qualified majority and the procedures for settlement should be specified in the legal instrument establishing the ECRM.
- Interference with contractual relations should be limited to those measures that are required to solve important collective-action problems.
- The integrity of the decision-making process under the mechanism should be safeguarded by an efficient and impartial dispute-resolution system.

These general principles suggest that the ECRM should involve three separate bodies: a legal one in charge of adjudication, an economic one to provide the necessary economic expertise and judgement, and a financial one dealing with financial assistance.

The legal body would have the authority to open a debt-restructuring procedure upon the request of a euro-area sovereign borrower and upon approval by the economic body that the debtor's debt is actually unsustainable. It would be a common judicial organ capable of sorting out and assessing claims by the parties, of ruling on disputes between creditors or between a creditor and the debtor, and of enforcing the decisions taken by the parties within the framework of the mechanism.

After the formal opening of the procedure, the economic body would have the task of calling for meetings of the borrower and the lenders and of guiding the negotiations with a view to finding a solution which would be acceptable to both sides. To fulfil this task, it would have i) to be able to review the economic and financial accuracy of a borrower's representation of its economic and financial situation and perspectives; ii) to evaluate the implications of any restructuring proposal for the borrower's outstanding debt (ie the extent of the haircut) and its sustainable level of debt going forward (ie the projected future path of primary budgetary surpluses). These functions require not only extensive information and economic and financial competence. They also require that all parties trust that the judgment of this body be not only neutral but also 'fair' in the sense that it seeks the right balance between too much and too little leniency towards the debtor.

The economic body would have the responsibility of assessing when a country is truly unable to meet its future financial obligations and by how much its debt needs to be reduced to solve that problem. There can be no simple test or rule for doing this, because a government can legally use its taxing powers to reduce citizens' income and make room for servicing the debt. However there are economic and social limits to the corresponding intra- and intergenerational transfers.[28] Reliance on judgment will therefore be inevitable. But what is

[28] This trade-off was accurately depicted by Jack Boorman (2003), the former head of the IMF's Policy Department, who wrote that: '*Debt can almost always be serviced in some abstract sense, through additional taxation and through the diversion of yet more domestic production to exports to generate the revenue and*

crucial is that such judgments are coherent across time and countries and that they are based on sound principles, above all on an evaluation of the level of primary budgetary surpluses that the country can generate in the future.

The financial body would have the tasks of providing short- or medium-term financing to the debtor country on behalf of the EU to enable it to undertake the necessary economic adjustment towards fiscal sustainability. Lending conditions should include a risk premium but not a penalty, in other words lending should be at rates charged by financial markets for governments with debt levels similar to those of the country in question after its restructuring.

The roles of the economic and the financial body are necessarily interlinked, although it is hard to say generally how closely. The critical question is: can an agreement between a borrower and its lenders be found without knowing the amount of financial assistance the former will receive afterwards? If so, the economic body can concentrate fully on the settlement between the borrower and the lenders and the financial body can subsequently negotiate the amount and terms of financial assistance with the borrower. If not, the amount of assistance must be determined by the economic body as part of the settlement process and this will give the bondholders incentives to hold out and force the economic body to make financial concessions to reach a settlement. This risk is likely to be a significant one. To mitigate it, any new lending under financial assistance should be given seniority over previous debt; also, the economic body should be able to provide an objective assessment of the financing needs, which calls for making it independent of the governments of the euro-area member states.

Various institutional arrangements can be conceived as regards the assignment of the legal, economic and financing functions of crisis resolution but, whatever the arrangement, these three roles should be fulfilled and distinguished in order to avoid creating conflicts of interest.

Our suggestion is that the legal role would be assigned to the European Court of Justice, whose mission is to ensure that 'the law is observed' in the interpretation and application of European treaties, to a specialised chamber within the court or, if preferred, to an entirely new institution.

The economic role should be given to an independent institution capable of providing the required assessment and of keeping a stance throughout the negotiations between creditors and debtor if the extent of the assistance becomes an argument in negotiations. This role should in our view accrue to the European Commission or to the European Commission jointly with the ECB.

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foreign exchange needed to service the debt. But there is a political and social, and perhaps moral, threshold beyond which policies to force these results become unacceptable.'

Finally, the natural choice for financial assistance would be the European Financial Stability Facility (EFSF), the new body set up and owned by the euro-area member states (Box 1).

Box 1. The EFSF

The EFSF is a special-purpose vehicle agreed to by the 16 euro-area member states on 9-10 May 2010 and designed to preserve financial stability in the euro area by providing financial assistance to member states in financial difficulty. It was established as a limited-liability company under Luxembourg law in June 2010. It is an intergovernmental body whose board comprises representatives of each of the 16 euro-area member states. The European Commission and the European Central Bank (ECB) can each appoint an observer to the EFSF Board.

The Facility has been operational since August 2010 and is able to issue bonds, notes or other debt instruments on the market backed by guarantees of €440 billion provided by the euro-area countries on a *pro-rata* basis, in accordance with their share in the paid-up capital of the ECB. Lending by the EFSF to member states in difficulty is subject to conditions to be negotiated with the European Commission in liaison with the ECB and the IMF and to be approved by the Eurogroup, the grouping of the euro-area finance ministers founded in 1997 and formally recognised by the 2009 Lisbon Treaty.

The EFSF is explicitly temporary. It can only facilitate the financing of loans agreed on or prior to 30 June 2013. The EFSF is to be liquidated at the earliest date after this deadline on which it no longer has any loans outstanding and all funding instruments as well as any reimbursement amounts due to the guarantor states have been repaid in full.

It should be emphasised, however, that financial support for the ECRM could only be extended by the EFSF if it acquired the status of a permanent European agency, whose membership could be limited to euro-area members or open to other EU countries as well. Indeed, as long as it remains a private company, loans by the EFSF to euro-area countries would have to be restructured in the same way as claims of any other private creditor if a country were to default. Similarly, existing loans by euro-area countries to Greece would have to be restructured under Paris Club procedures were the country to default. The only way to ensure full protection for EFSF claims on debtor governments would be to turn it into a European agency that would therefore enjoy seniority rights.[29]

How the ECRM would work

[29] Two models could be considered in this respect: either an independent institution akin to the ECB, or an agency whose governance would involve national governments like the EIB. As its role would be to provide temporary financial assistance with the guarantee of European governments, the second option would be more natural. In both cases procedures for decision-making would need to be agreed on. There is a strong case for not retaining the unanimity requirement of the current EFSF as it could severely hamper the institution's ability to act in the event of a crisis.

As discussed in the third part of this paper, the design of a crisis-resolution mechanism involves a series of delicate issues. We now turn to discussing how they would be addressed under our proposal.

One question about the ECRM is whether the EFSF should issue *'Brady bonds'* for governments whose debt has been restructured. That is, should the EFSF offer collateral for the principal amounts of new bonds issued by these governments, where the collateral would take the form of a zero-coupon bond issued by the EFSF and guaranteed by the EU or by the group of euro-area member states collectively? The main function of Brady bonds is to regain credit-market access for governments where the sustainability of their public finances is not firmly established. The holder of a Brady bond essentially obtains insurance for the principal amount of his loan against the risk that the borrower might default again. This implies that a debt-resolution mechanism that works efficiently has no need for Brady bonds. At the same time, the availability of such insurance might create incentives for incumbent bond holders to gamble in the restructuring negotiations, ie to insist on restructuring conditions which do not return the borrower to a state of sustainable public finances and to hope that good fortune will helping the borrower to repay its debt. This possibility of adverse incentives suggests that the ECRM should not involve Brady bonds.

A second question concerns the *scope of lending activity by the permanent EFSF*. In our view, financial assistance by the EFSF need not be restricted to lending to governments whose debt, having been deemed unsustainable, is restructured. In other words, there should be no automaticity between EFSF lending and restructuring. Access to EFSF lending should, under appropriate conditions (ie an economic adjustment programme and commitment by private banks to maintain exposure vis-à-vis the country), be open to a euro-area country that is willing and able to service its debt in full but is facing temporary liquidity problems. However, if the economic adjustment programme proved insufficient for the country to return to debt sustainability, restructuring of private-sector debt should proceed as swiftly as possible.

A third question is *whether and how the IMF should be involved*. Since it contributes to financial assistance to euro-area countries and plays an important role in assessing their public finances, involvement of the IMF with its expertise, negotiating capacity and financial resources would be natural. On the other hand the IMF is a global institution whose formal participation in a European debt-restructuring mechanism, which would have financial consequences for non-European creditors, would risk creating legal and political difficulties. For this reason the IMF should be consulted throughout the process but its formal participation should not, in our view, be a requirement.

A fourth question is *to whom debt restructuring would apply.* Fairness and efficiency call for making all creditors and all debt instruments liable to restructuring. The provisions of a future ECRM treaty would apply to all debt issued (or contracted) by a euro-area sovereign,[30] regardless of whether or not it is issued in euro or inside the euro area and whether it is held by euro-area residents or non-residents. This means that, although possibly issued outside the euro area and governed by foreign law, all disputes concerning euro-area sovereign debt would be adjudicated, in the event the ECRM is activated, by the judicial organ designated by the treaty. In addition, contrary to the usual practice of sovereign debtors to discriminate between domestic and foreign creditors, the ECRM would not make such a distinction, for two reasons. First, discrimination between domestic and foreign creditors would not be acceptable among members of the European Union. Second, the main justification for the difference of treatment - that domestic creditors are normally paid in domestic currency while foreign creditors are normally paid in foreign currency - does not hold in the euro area, since the euro is both the domestic currency of each country and the currency of many foreign creditors.

To be clear, the ECRM treaty would provide that all contracts entered into by a state that is a party to the treaty would be subject to the provisions of the treaty, notwithstanding any clause to the contrary. The treaty would thus become an element of the law governing the contract, whatever this law is (ie the law of the debtor state, or of another euro-area member, or of a non-euro-area country). Consequently, any activation of the mechanism would operate as if the contract included a collective-action clause, the terms of which would be those defined by the treaty. A foreign judge (eg in a US or UK court) who would be prepared to enforce a CAC as a contractual clause would also recognise the applicability of the treaty provisions (and the binding effect of decisions made under these provisions) as part of the law governing the contract.

A fifth and final question is what should be the *legal format of the proposed reform.* The ECRM could be established either through an EU directive or through the enactment of a treaty among the euro-area countries. The second solution has the disadvantage of being more cumbersome politically, but would nonetheless be preferable in our view to the alternative of enacting uniform national laws in all euro-area countries through an EU directive, which would increase the risk of discrepancies not only in the formulation of applicable rules among the participating countries but also in their interpretation and enforcement by the common judicial body. Adoption of a treaty does not imply, however, that enactment of some or all of the provisions in national laws could entirely be dispensed with. Such enactment would in fact remain necessary for those treaty provisions that may have to be invoked in national courts, in countries whose legal systems preclude the enforcement of treaty provisions that have not been incorporated in the country's domestic laws.

[30] The provisions of the treaty would only apply to debt issued (or contracted) by national governments since sub-national entities would not be parties to the treaty.

Financial regulation and market implications

The recent debt crisis has shown that there might be an important link between sovereign default and a bank crisis. Banks in the euro area, both inside and outside the country in distress, that hold large amounts of bonds issued by the defaulting country in their portfolios might lose access to the ECB's refinancing facilities and face severe liquidity shortages as a result of a default. Some observers have suggested that Greece was bailed out because the French and the German governments wanted to make sure that banks in their countries would not be destabilised by a collapse in the value of Greek government bonds.

It is important to recognise, first, that this is a transitional issue, although admittedly the transition phase might be long. Before the Greek crisis, banks in Germany, France and elsewhere bought and exposed themselves massively to Greek debt because they assumed that Greek debt, like other euro-area public debt, was essentially risk-free. This assumption was justified under pre-monetary union circumstances, when governments could print money to pay off their debts, but is no longer the case. Once banks have become familiar with the new regime and adjusted to it, they will limit their exposure to debt issued by countries that are at risk of default. As a result, the holders of the debt of such countries will demand an interest premium for the lack of liquidity of such bonds, thus rewarding governments that keep the risk of default low. This will be another element of market discipline strengthening the incentives for prudent fiscal policy.

This last point implies that the creation of a debt resolution mechanism in the euro area has important ramifications for financial market regulation. It implies that there is no longer a justification for special treatment of public debt in bank capital and liquidity requirements. Consistency of financial market policies, therefore, demands that banks be required to hold capital against public debt and that a mechanism of 'prompt corrective action' be put in place whereby banking supervisors impose progressive penalties against banks that exhibit deteriorating capital ratios. By the same token, the uneven quality of public debt will have to be recognised by the ECB when assessing the quality of the collateral posted by commercial banks. Regulatory changes along these lines would have two desirable effects:

- First, in the event of a debt crisis, such a mechanism would go a long way towards limiting the ability of banks to delay a sovereign-debt restructuring in the hope that the EFSF will have no choice but to bail them out.
- Second, in the steady state, banks and other institutions would know that, in the future, they may take substantial losses from holding government debt and providing loans to governments. Knowing that government debt is risky, banks and financial markets would price it more realistically and assure that they will not be exposed to

it excessively. This, in turn, would expose debt-issuing governments to market signals and give them stronger incentives to refrain from excessive debt accumulation.[31]

The financial crisis that began in 2007 and blew full force in September 2008 has already led to much larger differences in bond yields in the euro-area bond market than before. While yield differentials existed before and did respond to the fiscal performance of the member states, these differentials have become much larger and much more responsive to differences in debts and deficits than before the crisis.[32]

An important question is: what would the creation of a sovereign-debt resolution mechanism do to bond yields in the euro area? Would it risk making all debt more costly, as sometimes suggested? Empirical evidence shedding light on this question is hard to come by. Bradley et al. (2008) find that bond yields respond significantly to changes in legal rules affecting the uncertainty about repayment. From the perspective of an individual investor, however, it is not clear whether the introduction of a debt-resolution mechanism increases or reduces the uncertainty about repayment. This may explain why Bradley et al. do not find significant effects on bond yields as a result of the widespread introduction of collective-action clauses in emerging market bonds after 2003. Eichengreen and Mody (2004) compare the yield on bonds with and without collective-action clauses. They find that low-quality borrowers pay higher interest rates if they issue bonds with collective-action clauses than if they issue bonds without them. On the other hand, high-quality borrowers pay lower interest rates if they issue bonds with collective action clauses that if they issue bonds without them.

If anything, this evidence suggests that the introduction of rules for dealing with sovereign default will contribute to the tendency of markets to distinguish between high and low quality borrowers and to price loans and bonds accordingly. This would strengthen market discipline and contribute to the goal of sustainable public finances laid down in the European Treaty, and thereby to the sustainability of the euro itself.

[31] The mechanism would also be fully compatible with a dual debt regime along the lines of the Blue Bonds proposal of Delpla and von Weizsäcker (2010).

[32] See Schuknecht, Wolswijk and von Hagen (2009, 2010).

5 Conclusion

We have argued that the current architecture of European Monetary Union, which rests on the flawed assumption that sovereign-debt crises cannot happen, is incomplete and that EMU needs a crisis resolution mechanism – an ECRM.

Our proposal for such a mechanism draws on the lessons from international experience and builds on the response to the Greek crisis in spring 2010, especially the creation by the EU jointly with the IMF of a facility for temporary financial assistance to euro-area countries. As far as possible, we have sought to base our proposal on existing institutions and practices in order to limit the legal, institutional and financial implications of the creation of a crisis-resolution mechanism.

Difficulties currently abound and must be addressed head-on in order to avoid potentially damaging ambiguities and perverse incentives. For this reason, European governments should not let the understandable reluctance to revise the European Treaty stand in the way of the urgent need to build a sound institutional framework for the euro. We find it especially important to distinguish between the different legal, economic, and financial assistance roles involved in any crisis resolution and to invest these roles with the proper responsibility.

In creating such a mechanism, Europe is taking the lead where the international community failed to find agreement a decade ago. There are good reasons to think it has a fair chance to succeed, and we do not share the view of those who claim that no European solution can be found in the absence of a global solution. By the same token, however, we certainly consider that there would be significant benefits in the definition of a global response to the sovereign crisis-resolution issue, and we hope that Europe's decision to create a regional mechanism will help advance the global discussion.

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