

Lessons from the European Sovereign Debt Crisis

Towards a European Sovereign Debt Restructuring Mechanism

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2011 General University Honors Capstone

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ABSTRACT

The recent global financial crisis has highlighted the tensions created by both a lack of fiscal discipline and a single monetary policy for the disparate members of the EMU. Greece, Ireland, and Portugal have already opted for IMF and EU crisis financing in the face of mounting debt burdens. The quandary now facing the European Union is how to deal with such crises. This paper examines the effectiveness of the newly developed European crisis resolution mechanisms in two ways. First, it quantitatively analyzes the impact of the European Financial Stability Facility on market perceptions of risk and draws some implications for the proposed European Stability Mechanism. Second, it returns to a previous debate waged between statutory and contractual mechanisms for restructuring sovereign debt, and examines the applicability of these critiques in the specific case of the ESM.

Table of Contents

Introduction	2
The European Context	4
The Economic and Monetary Union's Original Sin(s).....	4
The Current Crisis: Causes and Consequences.....	7
<i>Greece</i>	<i>8</i>
<i>Ireland.....</i>	<i>10</i>
<i>Contagion?.....</i>	<i>11</i>
Responses Thus Far.....	13
Is Any Mechanism Necessary?	17
Collective Action Clauses vs. Sovereign Debt Restructuring Mechanism: A Review of the Literature	23
The Need for a Legal Mechanism for Sovereign Debt Restructuring.....	23
Collective Action Clauses: Pros and Cons.....	26
Sovereign Debt Restructuring Mechanism: Pros and Cons.....	31
CAC vs. SDRM and the ESM.....	38
How Relevant are CAC Criticisms?.....	39
How Relevant are SDRM Criticisms?	42
Conclusion: Cautious Optimism	46
<i>Data</i>	<i>52</i>
<i>Official Documents.....</i>	<i>52</i>

Introduction

The recent global financial crisis has highlighted the tensions created by both a lack of fiscal discipline and a single monetary policy for a disparate set of Eurozone countries, and has renewed debate about the viability of a currency union without an accompanying fiscal union.¹ Greece's balance sheet antics obscured billions of dollars in debts from European overseers² while low ECB rates accelerated an already booming Irish economy and allowed the development of a property bubble.³ The quandary now facing the European Union is how to deal with such crises. Greece, Ireland, and Portugal have already been forced to seek emergency financing from the EU and the IMF.

In May 2010, European leaders established the European Financial Stabilization Mechanism (€60 billion) and the European Financial Stability Facility (€440 billion) to provide emergency financing to countries facing liquidity crises.⁴ The seventeen Eurozone members are also currently developing a permanent mechanism to deal with future sovereign debt crises while preventing moral hazard on the part of member states and creditors. This European Stabilization Mechanism (ESM) calls for a two-track process, one for liquidity crises and one for sovereign insolvency. Collective action clauses are to be

¹ Antonio Martino, "Milton Friedman and the Euro," *Cato Journal* 28:2 (Spring/Summer 2008): pp. 266-67.

² Louise Story, Landon Thomas, and Nelson Schwartz, "Wall St. Helped to Mask Debt Fueling Europe's Crisis," *New York Times*, February 13, 2010, available online at <<http://www.nytimes.com/2010/02/14/business/global/14debt.html>>.

³ Philip R. Lane, "The Irish Crisis," *Institute for International Integration Studies* Discussion Paper No. 356, February 2011: pp. 2-3.

⁴ EFSF Framework Agreement, European Council June 7, 2010, p. 1, available at <http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf>.

included in all Eurozone member debt issued after 2013, which will facilitate negotiation with creditors in the case of insolvency.⁵

This discussion harkens back to a debate waged at the beginning of the last decade between statutory and contractual mechanisms for restructuring sovereign debt. Indeed, the pros and cons of each approach noted in the literature could provide valuable insights into how the Euro area member states should approach any permanent sovereign debt restructuring mechanism. Thus, this paper proceeds in two stages. First, it explores whether any crisis resolution mechanism is necessary through a quantitative examination of the impact of the EFSF on sovereign bond yields and the implications of these effects for the ESM. It then applies critiques of contractual and statutory mechanisms for sovereign debt resolution developed in the literature to the ESM in order to investigate possible flaws in its design.

Two key findings emerge from these endeavors. First, it appears that the introduction of the EFSF had a significant downward impact on bond yields for highly indebted sovereigns after its introduction in May 2010, suggesting institutional action by European leaders has been well received by markets. However, the rise in yields since the introduction of the EFSF suggests that the EFSF may not be enough; there may be a case for a mechanism to tackle both liquidity and solvency crises. Second, viewing the ESM through the lens of the collective action clause vs. sovereign debt restructuring mechanism debate reveals that the ESM, while technically maintaining a contractual framework for debt renegotiation, does create a “light-footprint” statutory presence that could potentially strengthen any renegotiation process. However, the major obstacle to realizing the goal of

⁵ Term Sheet on the ESM, European Council, March 24-25, 2011, p. 31, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf>.

an effective “permanent stability mechanism” remains the concern that the ESM’s response to future crises will be inexorably politicized, which would be deleterious to establishing a predictable process for dealing with sovereign debt crises.⁶

The rest of this paper is organized as follows. The second section describes the relevant institutions of the Economic and Monetary Union and serves as an introduction to the European sovereign debt crises and the solutions implemented to date. The third section examines the issue of whether any ex ante mechanism is necessary through a quantitative analysis of the EFSF’s impact on sovereign bond yields. The fourth section reviews the need for a legal mechanism for resolving sovereign debt crises and reviews the debate between contractual collective action clauses and statutory sovereign debt restructuring mechanisms, two competing proposals prominent within the academic and policy literature. The fifth section then applies the CAC vs. SDRM debate to the proposed ESM. The sixth section concludes.

The European Context

The Economic and Monetary Union’s Original Sin(s)

This section focuses on two key complementary aspects of the EMU framework that have a particular bearing on the current crisis: the Stability and Growth Pact and the European Central Bank. In addition to reviewing the performance of these two features of the monetary union, it addresses the theoretical debate over their role in propagating the current crisis.

The Stability and Growth Pact (SGP) was first suggested in the mid-1990s by German Finance Minister Theo Waigel and eventually incorporated into the Treaty

⁶ Ibid., p. 21.

Establishing the European Community as a way to ensure that member states continued to observe the Maastricht Convergence Criteria once the euro had been introduced.⁷ Given that the EMU has a centralized monetary policy but decentralized fiscal policy, fiscal discipline by member states was seen as crucial to maintaining price stability across the monetary union.⁸ A key aspect of this mechanism is the excessive deficit procedure, under which the Council of Ministers can penalize members for violating the fiscal criteria. If a country violates the deficit requirements, it is first subject to non-interest bearing deposits of 0.2% to 0.5% of its GDP. If within two years no corrective action is taken, these deposits are turned into fines.⁹ However as Kesner-Skreb points out, there is much room for the subjective assessment of the Council about whether to impose penalties¹⁰.

There have been two diametrically opposed criticisms of the SGP. First, as Zestos and Kenen & Meade point out, flexible fiscal policy is an important economic tool when national control over exchange rate and monetary policies has been surrendered. Thus, in the event of asymmetric shocks, the SGP could prevent member states from using deficit spending to stimulate their economies.¹¹ In the absence of a mechanism for fiscal transfers between member states, members would have to be reliant on their own resources in order to overcome economic shocks. On the flip side, some have argued that the SGP is too flexible and impossible to enforce, which is evidenced by the “creative accounting

⁷ Marina Kesner-Skreb, “Stability and Growth Pact,” *Financial Theory and Practice* 32:1 (2008): p. 83.

⁸ Peter B. Kenen and Ellen Meade, *Regional Monetary Integration*, Cambridge: Cambridge University Press, 2008: pp. 66-68.

⁹ George K. Zestos, *European Monetary Integration: The Euro*, Mason, Ohio: Thomson South-Western, 2006: p. 78.

¹⁰ Kesner-Skreb (2008), p. 84.

¹¹ Zestos (2006), p. 78; Kenen and Meade (2008), p. 69.

gimmickry used by many countries” to meet deficit requirements.¹² Indeed after France, Germany, Italy, and Portugal all violated the Maastricht criteria by 2002 without much consequence, the ineffectiveness of the SGP became clear. As of July 13, 2010, 24 out of the 27 members of the EU had excessive deficits.¹³

Under Article 105 of the Treaty Establishing the European Community, the European Central Bank (ECB) is solely responsible for monetary policy for the members of the Economic and Monetary Union. The ECB’s primary objective is price stability, and it is prohibited from financing government deficits or acting as a lender of last resort in liquidity crises, thus giving it a “narrow” mandate.¹⁴ However, in the current crisis, the ECB has been pressed into the de facto role of lender of last resort. In October 2008, it entered into a swap with Denmark, a non-Eurozone country, to allow it to defend its currency.¹⁵ It has also bought the sovereign debt of Greece, Ireland, and Portugal on the secondary market to narrow the spreads these countries face.¹⁶

The major criticism of a centralized monetary policy has emerged from the optimum currency area literature. In particular, Kenen & Meade observe the problems that have arisen from inflation persistence in the EMU.¹⁷ In a comparison between Eurozone countries and U.S. states, they find that while there are inflation differentials in both U.S. states and EMU countries, the former display both positive and negative differences with

¹² Martino (2008), p. 266.

¹³ European Commission Economic and Financial Affairs website, available at http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm.

¹⁴ Kenen and Meade (2008), p. 58.

¹⁵ Tasneem Brogger, “Denmark Strikes \$15 Billion Swap Agreement with ECB,” Bloomberg.com, October 27, 2008, available at <<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFLPJAmcHqzA>>.

¹⁶ Sakari Suoninen, “ECB Bond Buys Remain in Hibernation,” Reuters.com, April 21, 2011, available at <<http://www.reuters.com/article/2011/04/21/ecb-bonds-idUSFLALFE7MX20110421>>.

¹⁷ Kenen and Meade (2008), p. 111-12.

respect to average inflation, while the latter demonstrate greater persistence over time.

Thus, they argue that periphery members like Greece, Ireland, Portugal and Spain experienced the largest ex post decline in real interest rates from joining the EMU, due to a larger drop in nominal interest rates and an increase in inflation. This in turn fueled domestic demand and spurred additional inflation. At the same time, appreciation of real exchange rates due to inflation has also weakened these periphery countries' competitiveness.

Thus, two underlying flaws that have been present since the genesis of the EMU have been brought to the fore in the recent crises. First, states have often violated the SGP criteria for fiscal discipline with little consequence; indeed, as Kenen and Meade suggest, when the two drivers of European integration, France and Germany, effectively decided that they would not face fines even if they failed to correct their deficits, the SGP lost much of its credibility.¹⁸ Secondly, while the ECB remains the most independent central bank in the world, its ability to accommodate asymmetric shocks is limited by the fact that it is responsible for monetary policy for all EMU members.¹⁹ Specifically, the inflation persistence in periphery countries has reduced their competitiveness under the common currency.

The Current Crisis: Causes and Consequences

While both domestic and international factors contributed to the crises that have developed in Greece, Ireland, and most recently Portugal, the impetus for the crisis was different in each country, hinting at the nuances of the debt problems facing EMU countries.

¹⁸ Ibid., p. 73.

¹⁹ Zestos (2006), p. 91.

The sections below explore the salient aspects of the crises in greater detail and the EU responses to date.

Greece

Greece appears to be facing a “classic” sovereign debt crisis fueled by the government’s high borrowing to fund budget and current account deficits.²⁰ Rebecca Nelson, Paul Belkin & Derek Mix describe several factors that contributed to the government profligacy that sparked the crisis. On the domestic level, high government spending and low tax collection, coupled with an aging population contributed to the Hellenic Republic’s ballooning deficits. While central government expenditure grew by 87% in nominal terms between 2004 and 2010, tax revenues only grew by 31%. Inefficient public administration and complex tax codes have been named as factors that have resulted in high levels of tax evasion. Greece also maintains a generous pension system, replacing 70-80% of wages, but with the number of Greeks over 64 increasing, this has strained the country’s public finances.²¹

While access to capital at low interest rates and over-borrowing by the private sector have also been named as possible causes, Kevin Feathersone argues that the crisis can primarily be chalked up to the mismanagement of public finances.²² Indeed as he details, Greece’s penchant for misrepresenting its over-borrowing can be seen in its record of poor-quality data reporting. Already by 2004, an audit of Greece’s finances by the incoming Finance Minister George Alogoskoufis revised Greece’s budget deficit data to

²⁰ Rebecca M. Nelson, Paul Belkin, and Derek E. Mix, *Greece’s Debt Crisis: Overview, Policy Responses, and Implications*, Washington DC: Congressional Research Service, April 27, 2010: p. 2.

²¹ Ibid., pp. 4-5.

²² Kevin Feathersone, “The Greek Sovereign Debt Crisis and EMU: A Failing State in a Skewed Regime,” *Journal of Common Market Studies* 49:2 (March 2011): pp. 3-4.

above 3%; this resulted in an excessive deficit procedure that was only ended in 2007.²³

Further revelations showed that the country had violated the SGP deficit and debt criteria every year since joining the euro.²⁴ Ultimately, the spark for the current crisis occurred in a remarkably similar situation: in October 2009, the incoming Finance Minister, George Papakonstantinou, revised the deficit from 6.7% to 12.7%.²⁵

This surprise announcement was accompanied by accusations that banks like Goldman Sachs had helped Greece “obscure billions in debt” through exotic financial instruments;²⁶ for example, by borrowing billions through trading currencies at favorable exchange rates, Greece could report these transactions as swaps instead of loans.²⁷ Such revelations provoked investors’ concern; by April 27th, 2010, Standard & Poor’s had downgraded Greece’s long-term sovereign debt rating to “junk” status.²⁸ While the yield on Greek 10 year bonds fell upon the announcement of an EU/IMF aid package and accompanying austerity measures, yields have since trended upwards as there are growing expectations that Greece’s debt, which is projected to reach 152% of GDP in 2011, is indeed unsustainable.²⁹

²³ Ibid., p. 7.

²⁴ Nelson, Belkin, and Mix (2010): p. 6.

²⁵ Ibid., p. 3.

²⁶ Story, Thomas, and Schwartz (2010)

²⁷ Nelson, Belkin, and Mix (2010): p. 13.

²⁸ Niklas Magnusson, “Greek Banks to Face Mounting Pressure as S&P Lowers Credit Ratings to Junk,” Bloomberg.com, April 27, 2010, available at <<http://www.bloomberg.com/news/2010-04-27/greek-banks-to-face-mounting-pressure-as-s-p-lowers-credit-ratings-to-junk.html>>.

²⁹ *Fiscal Monitor, April 2011: Shifting Gears - Tackling Challenges on the Road to Fiscal Adjustment*, Washington, DC: International Monetary Fund, April 2011, p. 127, available at <<http://www.imf.org/external/pubs/ft/fm/2011/01/pdf/fm1101.pdf>>.

Ireland

In contrast, the Irish crisis originated not from within the public sector but from a property bubble that burst during the global financial crisis and put several private-sector Irish banks in severe distress. As Patrick Honohan notes, EMU entry triggered the Irish housing price surge by lowering real interest rates and creating greater incentives to take out mortgages.³⁰ In the 10 years until 2004, Dublin saw greater property appreciation than any other capital in the world.³¹ The boom in house prices set off a residential construction frenzy that well surpassed demand; 15% of the housing stock was vacant in 2006.³²

The signs that Irish banks were fueling the “irrational exuberance” of the property bubble were evident. By 2006, two thirds of loans to first time buyers had loan-to-value above 90%.³³ Bank balance sheets grew rapidly; using an annual balance sheet growth rate of 20% as a trigger, Honohan observes that each locally-owned Irish bank crossed this threshold in at least one year, with Anglo Irish Bank crossing it eight out of nine years.³⁴ Much of this expansion was enabled by wholesale funding from abroad rather than by domestic retail deposits.³⁵ Yet, despite these warning signs, the regulatory response was lax. Regulators tightened capital requirements on high LTV loans only marginally, and failed to enforce them as LTVs continued to grow. When they conducted stress tests, they assumed stresses that were too small and relied on banks’ own internal projections.³⁶

³⁰ Patrick Honohan, “Resolving Ireland’s Banking Crisis,” *The Economic and Social Review* 40:2 (Summer 2009): p. 208.

³¹ Orla O’Sullivan, “From Celtic Tiger to Celtic Mouse,” *Bank Systems & Technology* 46:3 (April/May 2009): p. 30.

³² Honohan (2009): p. 212.

³³ *Ibid.*, p. 215.

³⁴ *Ibid.*, pp. 216-17.

³⁵ Lane (2011): p. 8.

³⁶ Honohan (2009): p. 217.

Thus, when the property bubble did finally burst and the full exposure of Irish banks became evident, creditors were unwilling to roll over inter-bank funding to these banks. These problems were especially acute given the concentration of the Irish banking sector; Bank of Ireland and Allied Irish Bank alone hold three-quarters of the country's consumer accounts.³⁷ In a rush to rescue the banking sector, the Irish government issued a blanket guarantee of Irish banks' liabilities, including deposits, senior debt and dated subordinate debt, on September 30, 2008.³⁸ By December 2008, the losses on Irish banks' balance sheets were much larger than calculated, and the government found it necessary to recapitalize the three largest banks, effectively nationalizing Anglo-Irish bank.³⁹

As Lane concludes, Ireland's public finance crisis came as a result of these ill-conceived measures to bail-out private-sector borrowers.⁴⁰ The country faces a debt burden of 114.1% of GDP by 2011 and 123.5% of GDP by 2015.⁴¹ However, the question of whether Ireland is solvent remains less clear-cut for two reasons. First, the debt-to-GDP ratio could be tolerable at lower borrowing costs than what the government currently faces (the yield on Irish 10 year sovereign bonds was 10% as of March 31, 2011). Second, should the realized property losses be worse than projected, it could add to the debt burden and thereby push the government into perceived insolvency.⁴²

Contagion?

The crises in Greece and Ireland have also shaken investors' confidence in other European economies with large public debts. Portugal, with a projected 2011 debt to GDP

³⁷ O'Sullivan (2009): p. 30.

³⁸ Lane (2011): p. 15.

³⁹ Ibid., p. 16.

⁴⁰ Ibid., pp. 14-17.

⁴¹ *Fiscal Monitor*, April 2011: p. 127.

⁴² "Bite the Bullet," *The Economist*, January 13, 2011: p. 54.

ratio of 91%, and Spain, with a debt projection of 64% for 2011, in particular have felt the pressure of higher bond yields.⁴³ There seems to be general agreement that Spain is indeed solvent, despite problems in the banking sector, but Portugal has proved to be much more vulnerable. Compared to its Iberian neighbor, Portugal's economy is much smaller, and it depends much more on external financing. The potential for political turmoil following the resignation of the Prime Minister amid protests from opposition parties over proposed austerity measures also increased uncertainty about Portugal's ability and willingness to service its debt.⁴⁴ Indeed, on April 8, 2011, Portugal became the third Eurozone country to turn to the EU and IMF for a rescue package, which some believe will cost an estimated €90 billion.⁴⁵

One interesting question is whether the higher borrowing prices faced by Portugal and Spain reflect growing awareness of risky fundamentals or contagion effects. Michael Arghyrou and Alexandros Kontonikas explore this topic, finding that while certain fundamentals do have significant explanatory power over bond spreads, Greek spreads also have a statistically significant impact on bond spreads for other Eurozone countries. This impact was highest for Portugal, Ireland, and Spain, leading the authors to conclude that bond spreads have included at least some amount of contagion risk.⁴⁶ The possibility of contagion emphasizes the important role any European crisis resolution mechanism

⁴³ *Fiscal Monitor*, April 2011: p. 127.

⁴⁴ "Portugal PM Jose Socrates Resigns After Budget Rejected," BBC News, March 23, 2011, available at <<http://www.bbc.co.uk/news/world-europe-12841492>>.

⁴⁵ Patricia Kowsmann & Costas Paris, "Portuguese Bailout Terms Discussed," Wall Street Journal Online, April 8, 2011, available at <<http://online.wsj.com/article/SB10001424052748704013604576248254141025180.html>>.

⁴⁶ Michael G. Arghyrou and Alexandros Kontonikas, "The EMU sovereign-debt crisis: Fundamentals, expectations and contagion," *European Commission European Economy: Economic Paper* 436 (February 2011): p. 20.

must play in creating a predictable and effective backstop to prevent a crisis in any one country from spreading to others.

Responses Thus Far

While the European Union has pursued many strategies to control the fallout from these debt crises (for example the ECB's move to prop up sovereign bonds by buying them on the secondary market), two mechanisms are particularly relevant to this paper. In May 2010, in response to the growing crises in Greece and Ireland, the Eurozone countries created the European Financial Stability Facility to provide "swift and effective liquidity assistance" to countries facing financial distress.⁴⁷ Incorporated in Luxembourg, the EFSF acts a loan facility that member states may draw on in the event of liquidity crises. The total lending capacity of €440 billion can be financed by the issuance of "bonds, notes, commercial paper, debt securities" or other "funding instruments" backed by irrevocable and unconditional guarantees of the euro-area member states.⁴⁸

A member state drawing on these funds must enter into a memorandum of understanding (MoU) with the European Commission detailing the austerity measures it intends to institute in order to correct its imbalances. Following a Commission report on whether the borrower is complying with the terms of the MoU, the Guarantors (i.e. the other Eurozone countries) must agree unanimously before the EFSF can develop the formal terms of any loans, including maturity, interest rate, and amount.⁴⁹ Initially, it was thought that EFSF loans would be used solely to meet maturing obligations; however, the leaders of

⁴⁷ Statement by the Eurogroup, November 28, 2010, p. 1, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118050.pdf>.

⁴⁸ EFSF Framework Agreement, June 7, 2010: p. 3, available at <http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf>.

⁴⁹ Ibid., p. 8.

Eurozone countries have more recently agreed that, “as an exception,” the EFSF can intervene in primary debt markets.⁵⁰

Three key points can be drawn from the functioning of the EFSF. First, it is structured to deal only with liquidity crises; the EFSF Framework agreement does not contain any explicit provisions for cases where borrowers are already insolvent (though it does mandate that the EFSF take “into account debt sustainability” in negotiating the parameters of any debt sustainability agreement).⁵¹ Second, the EFSF is a very small organization (with a staff of only a dozen people). It is instead heavily reliant on *pre-existing* institutions, including the IMF. The German Debt Management Office and the European Investment Bank provide support for raising funds, while the European Commission and ECB, which already have monitoring power over member states, ensure compliance.⁵² Finally, to the degree that EFSF loans are contingent on the unanimous consent of guarantors, this creates room for political uncertainty as some countries face domestic pressure not to create these external contingent liabilities.⁵³ Indeed, after the recent Finnish elections, which increased the power of the euro-skeptic True Finns party, there is some concern about Finnish support for the Portuguese rescue package.⁵⁴

⁵⁰ Conclusions of the Heads of State or Government of the Euro Area, European Council Press Release, March 11, 2011, p. 3, available at <http://www.consilium.europa.eu//uedocs/cms_data/docs/pressdata/en/ecofin/119810.pdf>.

⁵¹ EFSF Framework Agreement, June 7, 2010: p. 8, available at <http://www.efs.europa.eu/attachments/efs_framework_agreement_en.pdf>.

⁵² “The European Financial Stability Facility (EFSF) – FAQ,” European Financial Stability Facility website, <http://www.efs.europa.eu/attachment/faq_en.pdf>.

⁵³ EFSF Framework Agreement, June 7, 2010: p. 8, available at <http://www.efs.europa.eu/attachments/efs_framework_agreement_en.pdf>.

⁵⁴ Jonathan Stearns & James Neuger, “Finnish Vote Dents Euro Area’s Debt-Crisis Shield, Analysts Say,” Bloomberg.com, April 18, 2011, available at <<http://www.bloomberg.com/news/2011-04-18/finnish-vote-dents-euro-area-s-debt-crisis-shield-analysts-say.html>>.

The EFSF was justified by a rather “heroic” interpretation of Article 122.2 of the Treaty on the Functioning of the European Union,⁵⁵ which states that Union financial assistance can only be granted to a Member State with “severe difficulties caused by...exceptional occurrences beyond its control.”⁵⁶ First, it is clear that Greece’s profligacy and Ireland’s lax bank regulations were largely *within* those countries’ control, so the use of this clause seems to be a case of Eurozone leaders simply rationalizing their actions by paying lip service to the Treaties. However, more importantly, the clause implies that any aid is temporary and on a case-by-case basis; thus Article 122.2 cannot be used to justify creating a permanent crisis mechanism. Indeed, the EFSF will be liquidated as soon after 30 June 2013 as there are no longer loans to member states outstanding and all funding instruments have been paid in full.⁵⁷

The European Stabilization Mechanism, which will be activated in 2013 and will serve as the European Union’s permanent crisis resolution mechanism, expands on the model created by the EFSF. However, it is important to note that the ESM will not conceivably be involved in the present sovereign debt crises facing the EMU, but instead will serve as a tool to address future financial troubles. The most detailed framework for this mechanism to date was agreed upon at the March 24 – 25, 2011 meeting of European leaders. Much like the EFSF, the ESM is designed to provide financial assistance to countries whose difficulties threaten the stability of the euro. ESM aid is also conditional on

⁵⁵ Leszek Balcerowicz, “Sovereign Bankruptcy in the European Union in the Comparative Perspective,” *Peterson Institute for International Economics Working Paper* 10-18 (December 14, 2010): p. 18.

⁵⁶ Article 122.2, Consolidated Version of the Treaty on the Functioning of the European Union, *Official Journal of the European Union* 115:47 (2008).

⁵⁷ EFSF Framework Agreement, June 7, 2010: p. 20, available at <http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf>.

strict adjustment programs negotiated under memoranda of understanding; like EFSF, it is distributed primarily through loans, but can also be used to intervene in debt primary markets. The ESM's expanded lending capacity of €500 billion will consist of paid-in capital, committed callable capital, and guarantees; contribution is proportionally based on ECB paid-in capital.⁵⁸

However, unlike the EFSF, the ESM will not be as lean an organization, nor will it be organized as an autonomous corporation or *Société Anonyme*. Instead, it will be formed as an intergovernmental body, with a board of governors consisting primarily of finance ministers of euro-area states at the helm and a board of directors to implement day-to-day tasks. Additionally, since a permanent mechanism cannot be justified under Article 122.2, the ESM will be created by amending Article 136 of the Treaty of the Functioning of the European Union. The activation and disbursement of financial assistance under the ESM also differs from the equivalent process under EFSF in four major ways. First, the Board of Governors decides upon the terms of any assistance package and the accompanying adjustment program based on a qualified majority of 80% of votes weighted by contribution (rather than unanimous consent of guarantor countries required under EFSF). Second, after a request by a European government, activation of the fund is first contingent on a debt sustainability analysis conducted by the Commission in liaison with the IMF and the ECB; this analysis will be based on IMF practice.⁵⁹

Third, arising from the debt sustainability analysis, the ESM creates a two-track process for borrowing countries. If the sustainability analysis concludes that the borrower

⁵⁸ Term Sheet on the ESM, European Council, March 24/25, 2011, p. 24, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf>.

⁵⁹ Ibid., p. 29.

is simply illiquid, the ESM will provide assistance and ensure that the borrowing country takes steps to encourage major private investors to maintain exposure (the “Vienna Initiative” approach).⁶⁰ However, if the analysis reveals that the country is indeed insolvent, it will “be required to engage in active negotiations in good faith with its creditors” to restructure its debt.⁶¹ The ESM will only grant financial assistance contingent on the borrower having a “credible plan...to ensure adequate and proportionate private sector involvement” and will monitor the implementation of any such plan.⁶² In order to facilitate such negotiations, the ESM mandates the inclusion of standardized CACs in all member country debt beginning in July 2013 and sets out four main principles (proportionality, transparency, fairness, and cross-border coordination) that should govern any restructuring negotiations.⁶³ A fourth and final difference between the EFSF and ESM is that while the former does not retain preferred creditor status but is treated as any other sovereign claim, the latter does enjoy preferred creditor status second only to the IMF.⁶⁴

Is Any Mechanism Necessary?

An important first question to ask is whether any ex ante mechanism for crisis resolution is necessary in Europe. This concern can be explored in two related ways. First, one can examine whether the EFSF, the current ad hoc crisis resolution mechanism, has had any impact on market perception of the riskiness of sovereign debt for highly indebted European countries. Second, given that, as suggested above, the ESM will be more

⁶⁰ Ibid., p. 30.

⁶¹ Ibid., p. 30.

⁶² Ibid., p. 30

⁶³ Ibid., pp. 30-31.

⁶⁴ Ibid., p. 32.

comprehensive than the EFSF, is there any reason to believe that expanding its scope beyond that of the EFSF is justified.

A rudimentary econometric analysis can provide insight into the first concern. Market perception of sovereign debt risk is operationalized by looking at daily bond yield data on 10-year sovereign bonds for Greece, Ireland, and Portugal, the three countries with the largest imbalances.⁶⁵ Using ARMA processes, the first difference in each sovereign's bond yield is regressed against its own lag values, lag values of change in the other two countries' bond yields, a series of random shocks (in order to reduce serial correlation in the residuals), and a dummy variable obtaining a value of 1 after May 9, 2010 (the day the EFSF was officially announced).⁶⁶ The sample period goes from March 5, 2010 through July 23, 2010, allowing for approximately 8 weeks both before and after EFSF was created. Thus the regression looks like:

$$\Delta y_{it} = \alpha + \sum_{s=1}^6 \beta_s \Delta y_{i,t-s} + \sum_{s=1}^3 \gamma_s \Delta y_{j,t-s} + \sum_{s=1}^3 \delta_s \Delta y_{k,t-s} + \lambda EFSF + \sum_{s=1}^{s=6} \pi_s \varepsilon_{t-s} + \varepsilon_t$$

where:

- Δy_{it} is the first difference of 10 year sovereign bond yield for country i at time t .
- $i, j,$ and k are the three countries.
- EFSF is a dummy variable for the creation of the European Financial Stability Facility.
- ε_t is white noise.

The results for each country are noted in Table 1 below. Two important conclusions can be drawn from the reported results. First, the coefficient on the EFSF dummy variable

⁶⁵ Data obtained from Bloomberg database, Bloomberg L.P. on April 1, 2011.

⁶⁶ The first difference is used in order to ensure stationarity of the series.

is highly and negatively significant at the 1% level for all three countries. This downward effect of the EFSF has the greatest magnitude for Greece and the lowest for Ireland. It is thus reasonable to conclude that actions by European leaders to form an institution to provide liquidity assistance to member states was received well by markets, as is evidenced by the sharp fall in the change in long term yields following its introduction.

A second interesting finding is the interrelation between the sovereign bond yields of different countries. While the significance of past changes of a country's yield on the current value is to be expected, the results also demonstrate correlation between the yields of different member states. However, the direction of the interaction seems to be mixed. For Portugal, all three of the coefficients on lagged values of Greek and Irish yields that are significant demonstrate an inverse relationship. For Ireland, three of the four are inversely related. This result seems counterintuitive, since one would expect that the interrelated banking crises in each country and adverse market perception would result in yields moving in the same direction. This expectation is borne out in the results for Greece; two of the three significant lagged values of Irish and Portuguese yields have a positive relationship with Greek yields.

Even though there is a significant negative relationship between the EFSF and changes in long-term bond yields for Greece, Ireland, and Portugal, there may still be reasons for developing a more comprehensive mechanism like the ESM. Here, an important distinction needs to be made between the yield level and its first difference (i.e., the change in the yield). In interpreting the results of the above regressions, one can only say that the creation of the EFSF resulted in a significant fall in the change in sovereign yields. This could be indicative of lower volatility, but does not say anything about the level of yields.

Indeed, as the graphs of 10 year bond yields for Greece, Ireland, and Portugal (in Figure 1, below) indicate, while yield movements have not been as sharp after May 2010, for all three countries they have tended upwards, and by March 2011, had risen to levels higher than before the creation of the EFSF.

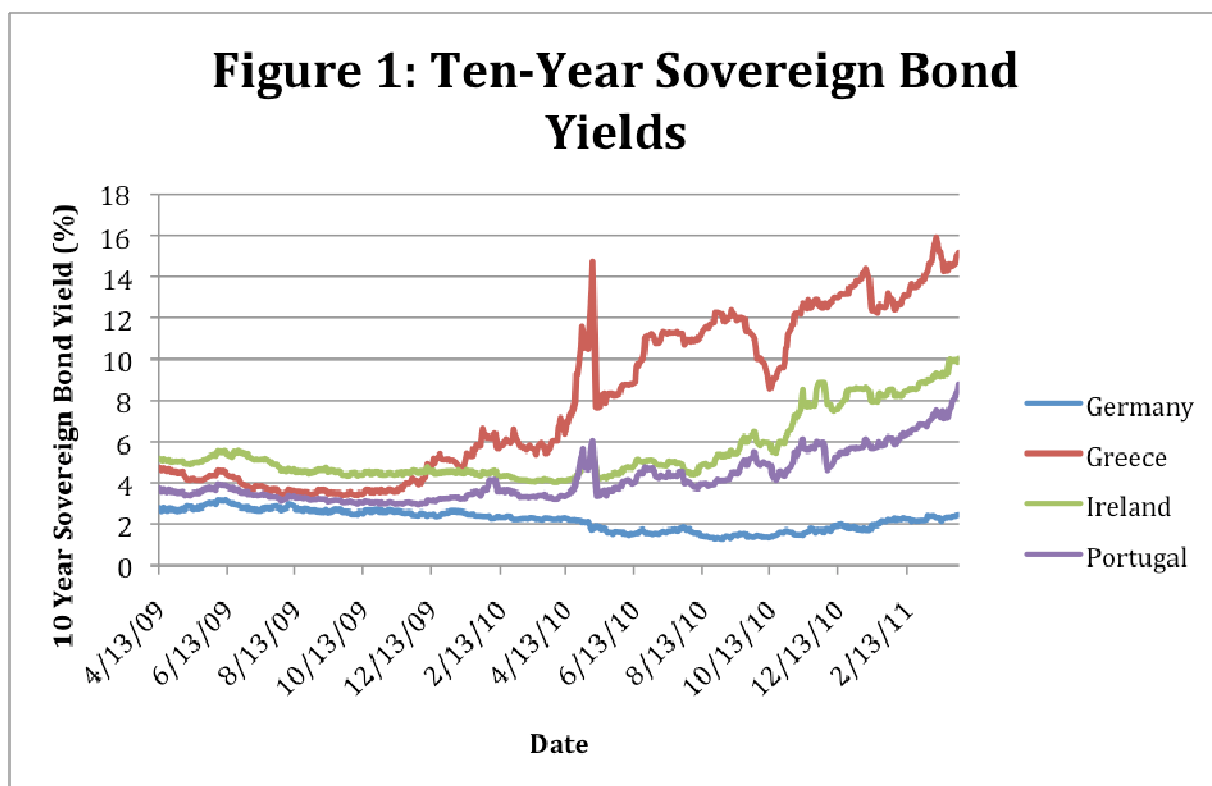
One possible explanation for this may be the growing perception in financial markets that these countries are in fact insolvent. Repeated credit downgrades and rising credit default swap costs on these sovereigns' debt suggest seem to indicate that investors are pricing in a significant default risk.⁶⁷ However, as noted above, the EFSF has no capability to deal with sovereign insolvency. As consensus begins to grow that Greece, and potentially Ireland and Portugal, will need to restructure their debt, the stabilizing role of the EFSF will likely be limited.

Thus, two tentative conclusions can be drawn about the ESM. To the degree that it builds upon the EFSF's loan facility, it may help to reduce the volatility in sovereign yields, much like the EFSF has already done in the current crisis. However, by developing a procedure for the orderly handling of sovereign insolvency, alongside its liquidity assistance program, it may help stabilize expectations about the default process on the part of both sovereigns and creditors. Committing to an ex ante process reduces the likelihood of ad hoc bailouts; countries (and their creditors) will be aware of the painful restructuring process that awaits them should their debt burdens become unsustainable.⁶⁸ In turning to an exploration of the ESM's debt restructuring component, this paper first revisits the

⁶⁷ "Bite the Bullet" (2011): p. 54.

⁶⁸ Beatrice Weder di Mauro and Jeromin Zettelmeyer, "A European Debt Restructuring Mechanism as a tool for Crisis Prevention," *voxeu.org*, November 26, 2010: p. 1, available at <<http://www.voxeu.org/index.php?q=node/5845>>.

literature on the need for a legal mechanism for sovereign debt restructuring and the critiques of contractual and statutory mechanisms for accomplishing these restructurings.



Source: Bloomberg Professional Services

TABLE 1: EFSF & Sovereign Bond Yields

Greece ($\Delta y_{\text{Greece},t}$)		Portugal ($\Delta y_{\text{Portugal},t}$)		Ireland ($\Delta y_{\text{Ireland},t}$)	
Variable	Coefficient	Variable	Coefficient	Variable	Coefficient
α	2.451472** (0.373093)	α	0.785040** (0.154367)	α	0.169422*** (0.050058)
$\Delta y_{\text{Greece},t-1}$	1.610828*** (0.163746)	$\Delta y_{\text{Portugal},t-1}$	-0.587509*** (0.148285)	$\Delta y_{\text{Ireland},t-1}$	-0.460313 (0.281630)
$\Delta y_{\text{Greece},t-2}$	0.941355*** (0.247214)	$\Delta y_{\text{Portugal},t-2}$	-0.417676** (0.224888)	$\Delta y_{\text{Ireland},t-2}$	-0.350134 (0.293520)
$\Delta y_{\text{Greece},t-3}$	-0.161177 (0.145691)	$\Delta y_{\text{Portugal},t-3}$	-0.850527*** (0.185218)	$\Delta y_{\text{Ireland},t-3}$	0.462225* (0.256801)
$\Delta y_{\text{Greece},t-4}$	3.123680*** (0.605763)	$\Delta y_{\text{Portugal},t-4}$	-0.828983** (0.106072)	$\Delta y_{\text{Ireland},t-4}$	-0.406400*** (0.129570)
$\Delta y_{\text{Greece},t-5}$	2.660351*** (0.440725)	$\Delta y_{\text{Portugal},t-5}$	-0.649629*** (0.098490)	$\Delta y_{\text{Ireland},t-5}$	-0.417349*** (0.111067)
$\Delta y_{\text{Greece},t-6}$	-1.346620 (0.549245)	$\Delta y_{\text{Portugal},t-6}$	-0.291739*** (0.057617)	$\Delta y_{\text{Ireland},t-6}$	-0.272992** (0.117177)
$\Delta y_{\text{Ireland},t-1}$	0.769151 (0.515837)	$\Delta y_{\text{Ireland},t-1}$	-0.428959*** (0.182779)	$\Delta y_{\text{Greece},t-1}$	-0.303349*** (0.055913)
$\Delta y_{\text{Ireland},t-2}$	1.702094** (0.785622)	$\Delta y_{\text{Ireland},t-2}$	-0.396875 (0.244187)	$\Delta y_{\text{Greece},t-2}$	-0.205178*** (0.073425)
$\Delta y_{\text{Ireland},t-3}$	-0.840223 (0.840202)	$\Delta y_{\text{Ireland},t-3}$	-0.148979 (0.178041)	$\Delta y_{\text{Greece},t-3}$	-0.129877** (0.059514)
$\Delta y_{\text{Portugal},t-1}$	1.201774*** (0.389337)	$\Delta y_{\text{Greece},t-1}$	-0.106090*** (0.039142)	$\Delta y_{\text{Portugal},t-1}$	0.596349*** (0.201151)
$\Delta y_{\text{Portugal},t-2}$	-1.068998 (0.568185)	$\Delta y_{\text{Greece},t-2}$	-0.161957*** (0.060995)	$\Delta y_{\text{Portugal},t-2}$	0.240498 (0.273094)
$\Delta y_{\text{Portugal},t-3}$	-1.164716** (0.435407)	$\Delta y_{\text{Greece},t-3}$	-0.022957 (0.043036)	$\Delta y_{\text{Portugal},t-3}$	-0.081613 (0.227297)
EFSF	-3.483578*** (0.316962)	EFSF	-1.041933*** (0.120048)	EFSF	-0.213862*** (0.061751)
***p<0.01; **p<0.05; *p<0.1					
Standard Errors are in parentheses					
R-squared	0.783938	R-squared	0.791218	R-squared	0.551026
Adjusted R-squared	0.728462	Adjusted R-squared	0.737611	Adjusted R-squared	0.457733
S.E. of regression	0.302207	S.E. of regression	0.105673	S.E. of regression	0.101861
Sum squared resid	6.758372	Sum squared resid	0.826350	Sum squared resid	0.798931
Mean dependent var	0.044245	Mean dependent var	0.013883	Mean dependent var	0.010266
S.D. dependent var	0.579949	S.D. dependent var	0.206297	S.D. dependent var	0.138326
Akaike info criterion	0.630896	Akaike info criterion	-1.470623	Akaike info criterion	-1.568196
Schwarz criterion	1.172023	Schwarz criterion	-0.929496	Schwarz criterion	-1.108238

Collective Action Clauses vs. Sovereign Debt Restructuring Mechanism: A Review of the Literature

The Need for a Legal Mechanism for Sovereign Debt Restructuring

The argument for a legal mechanism to efficiently deal with sovereign debtors is hardly new; as Jonathan Blackman and Rahul Mukhi note, such proposals have been around since the time of Adam Smith.⁶⁹ However, while innovations in contracts with private debtors evolved, so that by the end of the nineteenth century English law had introduced majority action clauses while U.S. law had put in place a statutory process of equity receivership, attention has returned to the subject of sovereign debtors only recently.⁷⁰ Driven by the shifting identity of lending from bank syndicate loans to disparate bondholders in a variety of jurisdictions,⁷¹ the erosion of absolute sovereign immunity, and a wave of emerging market debt restructurings, several arguments have been put forth as to why a legal mechanism may be necessary at the supranational level.⁷²

First, incomplete information in debtor-creditor relations may generate a collective action problem, particularly in the case of sovereigns. As Jonathan Sedlak points out, for sovereign nations, the determination of insolvency may be a function of their political will to impose harsh austerity programs and tax their citizens, rather than a simple analysis of

⁶⁹ Jonathan Blackman and Rahul Mukhi, "The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and other Legal Fauna," *Law and Contemporary Problems* 73:4 (Fall 2010): p. 48.

⁷⁰ Lee C. Buchheit, C. Mitu Gulati, and Ashoka Mody, "Sovereign Bonds and the Collective Will," *Emory Law Journal* 51:4 (2002): p. 3.

⁷¹ Nancy P. Jacklin, "Addressing Collective Action Problems in Securitized Credit," *Law and Contemporary Problems* 73:4 (Fall 2010): p. 175.

⁷² Ugo Panizza, Frederico Sturzenegger, and Jeromin Zettelmeyer, "The Economics and Law of Sovereign Debt and Default," *Journal of Economic Literature* 47:3 (2009): p. 654.

assets and liabilities.⁷³ Since this will is not known ex ante to the investor, the sovereign may find it in its interest to keep the information private and delay restructuring in the hope of avoiding painful adjustment costs. In relation to the debtor, creditors may also wish to keep the haircut they could accept private in hopes of reaching a higher payoff. However, the strategic bargaining that ensues only delays the eventual restructuring and often increases the size of the accompanying adjustment.⁷⁴

Inter-creditor coordination problems also might create inefficiencies in debt restructuring. Nouriel Roubini and Brad Setser note that creditors, fearing a sovereign may be unable to meet its liabilities, face incentives not to roll over claims, creating a “rush to the exits” that pushes illiquid borrowers into insolvency.⁷⁵ Carlos Arteta and Galina Hale empirically show that during debt renegotiations, foreign credit to the private sector of the borrowing country falls by an average of 20%, with obvious negative implications for production and future growth.⁷⁶ Creditor holdouts, especially by vulture funds that acquire distressed assets at fire-sale prices, could pose another problem.⁷⁷ While all creditors would be better off through a coordinated restructuring, individually they would get a better payoff if they held out while other creditors restructured. However, if enough creditors hold out, the restructuring cannot go forward.⁷⁸ Though in fact no sovereign

⁷³ Jonathan Sedlak, “Sovereign Debt Restructuring: Statutory Reform or Contractual Solution,” *University of Pennsylvania Law Review* 152:4 (April, 2004): p. 1488.

⁷⁴ Andrew G. Haldane et al, “Analytics of Sovereign Debt Restructuring,” *Bank of England Working Paper* 203 (2003): p. 11.

⁷⁵ Nouriel Roubini and Brad Setser, “The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions, and the Argentine Episode,” *Journal of Restructuring Finance* 1:1 (2004): p. 2.

⁷⁶ Carlos Arteta and Galina Hale, “Sovereign Debt Crises and Credit to the Private Sector,” *Federal Reserve Bank of San Francisco Working Paper* 21 (December 2006): p. 19.

⁷⁷ Blackman and Mukhi (2010): p. 49.

⁷⁸ Sedlak (2004): p. 1493.

restructuring has ever encountered this problem, it is potentially acute under traditional New York law bonds, which require a unanimous vote of bondholders to amend the key payment terms of a bond.⁷⁹ Additionally, while informal rules governing the treatment of different bond issues exist, there is no de jure priority structure for different categories of sovereign debt.⁸⁰

Roubini and Setser note that there is also the potential problem of “a rush to the courthouse” by individual creditors to enforce claims against sovereign debtors, which could disrupt the restructuring process.⁸¹ However, Panizza, Sturzenegger, and Zettelmeyer correctly point out that such litigation is often ineffective and that limited collection remedies increase creditor wariness.⁸² In the absence of an international bankruptcy regime, there is no direct way to enforce creditor claims against profligate sovereigns; a sovereign can in no way be “liquidated” in the sense that corporations are.⁸³

Thus, there was a view among certain academics and policymakers that some form of legal mechanism was necessary in order solve the alleged debtor-creditor and inter-creditor collective action problems while protecting the interests of both sovereigns and investors. In the early 2000s, two proposals emerged as the primary alternatives for implementing such a legal mechanism. The debate over which one to adopt centered largely over which one better resolved the potential problems discussed above.

⁷⁹ Buchheit, Gulati, and Mody (2002): p. 10.

⁸⁰ Roubini and Setser (2004): p. 3.

⁸¹ Ibid., p. 2.

⁸² Panizza, Sturzenegger, and Zettelmeyer (2009): p. 661.

⁸³ Sedlak (2004): p. 1509.

Collective Action Clauses: Pros and Cons

The first proposal, collective action clauses (CACs) in sovereign bond contracts, was introduced as a contractual, market-based approach to sovereign debt restructuring. The 2002 G-10 Working Group on Contractual Clauses listed several recommendations for the content of such CACs, which were debated and fleshed out elsewhere in the literature. First, the G-10 recommendations advocated the use of majority amendment clauses permitting a qualified majority of bondholders to bind all bondholders to a renegotiation of the payment terms of a bond or to an exchange of outstanding bonds for new debt instruments.⁸⁴ There are, however, two different approaches to defining the voter base. English law bonds utilize a quorum approach based on the percentage of all bonds represented at a meeting of bondholders, while U.S. investors have favored defining the requisite majority based on the outstanding principal amount. A second issue was the threshold for the qualified majority. While the G-10 working group noted that “75% would be a reasonable threshold”⁸⁵ Brazil and Venezuela went on to use CACs with 85% approval thresholds.⁸⁶ Also, as Sergio Galvis and Angel Saad suggested, since it is tough to balance interests of the minority of creditors with the prevention of creditor holdouts, the appropriate threshold to some degree was bound to be arbitrary.⁸⁷

A second key aspect of collective action clauses was the election of a bondholder representative to serve as an interlocutor between creditors and the in restructuring negotiations. The G10 working group recommended an approval threshold of 66 2/3% to

⁸⁴ Report of the G-10 Working Group on Collective Action Clauses, September 26, 2002: p. 2.

⁸⁵ Ibid., pp. 3-4.

⁸⁶ Sergio J. Galvis and Angel L. Saad, “Collective Action Clauses: Recent Progress and Challenges Ahead,” *Georgetown Journal of International Law* 35:4 (2004): p. 720.

⁸⁷ Ibid., p. 11.

provide such a representative with sufficient flexibility.⁸⁸ However, as Galvis & Saad note, countries have since adopted this structure to varying degrees; while Mexico did not opt for the trust structure at all, Uruguay allowed for a very limited role for the bondholders' representative.⁸⁹

A final purpose of CACs in sovereign debt was the attempt to prevent disruptive legal action on the part of individual creditors through the creation of engagement clauses, whereby the bondholders' representative would retain the sole power to initiate litigation upon instruction of 25% of bondholders and to distribute any recovery proceeds on a *pro rata* basis.⁹⁰ This practice was already common under English Law, but would be new under New York law contracts, and was meant to be useful by specifying the appropriate procedures immediately before and during restructuring, which is when panicked creditors might "rush to the courthouse."⁹¹

Several authors have touted the benefits of collective action clauses as a workable solution to the problems posed by sovereign debt restructuring. Empirically, Kenneth Kletzer⁹² and Haldane et al⁹³ demonstrated that CAC supermajority cramdown clauses effectively resolve the alleged creditor holdout problem, and thus could reduce any creditor-related delays that result in reduced capital flows and hamper debtor country growth.⁹⁴ However, Kletzer assumed zero costs of renegotiation,⁹⁵ whereas the conclusion

⁸⁸ Report of the G-10 Working Group on Collective Action Clauses (2002): p. 3.

⁸⁹ Galvis and Saad (2004): p. 9.

⁹⁰ Report of the G-10 Working Group on Collective Action Clauses (2002): p. 6.

⁹¹ Roubini and Setser (2004): p. 2.

⁹² Kenneth Kletzer, "Sovereign Bond Restructuring: Collective Action Clauses and Official Crisis Intervention," *IMF Working Paper #134* (June, 2003): p. 21.

⁹³ Haldane et al (2003): p. 19.

⁹⁴ Arteta and Hale (2006): p. 19.

⁹⁵ Kletzer (2003): p. 21.

in Haldane et al holds only under assumptions of common information.⁹⁶ Further, to the extent that it streamlined debtor/creditor interactions in renegotiations (through a trust structure), it was argued that CACs could help ameliorate the problem of a “rush to the courthouse” and a “rush to the exits” by increasing predictability.⁹⁷ Buchheit, Gulati, and Mody also showed that a qualified majority vote by bondholders could be used to legally subordinate outstanding bond issues to fresh financing during the restructuring⁹⁸. The ability to allow for debtor-in-possession financing through CACs might be potentially very beneficial, since Arteta and Hale argued that the reduction in foreign lending to the indebted sovereign’s private sector is less when the restructuring is accompanied by fresh financing.⁹⁹

A third line of support for collective action clauses came from the practicality of its implementation. Majority amendment clauses already existed as market practice under English Law and were quickly becoming accepted in sovereign debt contracts under New York law. While initially there were fears that CACs would make it easier for borrowers to default, which in turn would raise borrowing costs as investors priced in this risk, such suspicions have not been borne out in practice. Mexico, followed by several other emerging market economies, introduced CACs in 2003 without any measurable adverse market reaction.¹⁰⁰ Indeed, Barry Eichengreen and Ashoka Mody demonstrated that for more creditworthy countries, CACs actually appeared to lower borrowing costs.¹⁰¹

⁹⁶ Haldane et al (2003): p. 18.

⁹⁷ Sedlak (2004): p. 1483.

⁹⁸ Buchheit, Gulati, and Mody (2002): pp. 26-28.

⁹⁹ Arteta and Hale (2006): pp. 21-22.

¹⁰⁰ Jacklin (2010): pp. 184-85.

¹⁰¹ Barry Eichengreen and Ashoka Mody, “Would Collective Action Clauses Raise Borrowing Costs,” *NBER Working Paper 7458* (January, 2000): p. 17.

On the other hand, the criticisms of collective action clauses came from four directions. The first source was the lack of convergence in CAC terms.¹⁰² As discussed earlier, disparities existed in the voter base, approval threshold, and mechanisms for debtor/creditor interactions (trust structures vs. fiscal agency). Such inconsistencies negated the market clarity that was the ultimate goal of CACs and could make investors hesitant about which type of CAC to choose in order to better protect their interests. It was also thought difficult to introduce uniform CAC terms since they would be implemented individually by diverse sovereign nations. A second, related criticism was that without some sort of supranational mandate, it would be difficult to convince countries to include such clauses in their sovereign bonds, since CACs commit them *ex ante* to a certain procedure for restructuring.¹⁰³ Indeed, Patrick Bolton and Olivier Jeanne showed that in a simple model of inter-temporal consumption smoothing, in equilibrium adoption of “renegotiation-friendly clauses” would be inefficiently low.¹⁰⁴

The third critique was that while CACs might solve problems of inter-creditor coordination, they would do little to ameliorate the bargaining problem between the sovereign and its creditors engendered by incomplete information. Haldane et al. demonstrated that without the presence of a third party to observe the private valuations of debtor and creditor and to verify their claims, there would be inefficient delays in restructuring.¹⁰⁵ Roubini and Setser argued that while CACs would provide a short-term framework for negotiation, international institutions would need to be involved in medium

¹⁰² Galvis and Saad (2004): p. 11.

¹⁰³ Anne Krueger, *A New Approach to Sovereign Debt Restructuring*, Washington, DC: International Monetary Fund, 2002: pp. 31-32.

¹⁰⁴ Patrick Bolton and Olivier Jeanne, “Structuring and Restructuring Sovereign Debt: The Role of Seniority,” *NBER Working Paper Series* 11071 (June 2005): p. 5.

¹⁰⁵ Haldane et al (2003): p. 25.

term policy conditionality and other overarching structural issues that bear on a country's ability to successfully renegotiate its debts.¹⁰⁶

However, the most damning criticism leveled at CACs was that they only allow for qualified majority renegotiation and election of bondholder representatives within individual issues. Krueger, for example, argued that forcing sovereigns to renegotiate their debt one bond issue at a time would be hugely inefficient; the respite offered by dealing with one bondholders' representative in a restructuring might be offset if the sovereign had to deal with several bondholder representatives who represent different issues and are all able to initiate litigation against the sovereign.¹⁰⁷ While Kletzer argued that in the absence of negotiation costs, mutual gains lead to an equilibrium that should permit restructuring across issues,¹⁰⁸ Eichengreen and Mody showed that in fact "markets do not solve problems of aggregation on their own at zero cost;"¹⁰⁹ investors do perceive aggregation costs arising from information sharing and coordination across issues.

One solution found was the aggregation mechanism implemented by Uruguay, whereby restructuring can be conducted based on an approval threshold of 85% of outstanding principal of all relevant bonds and 67% of each individual bond issue. However, this would only apply to bonds issued under the same governing law, raising questions about aggregation across jurisdictions.¹¹⁰ Also, it was argued that such a

¹⁰⁶ Roubini and Setser (2004): p. 12.

¹⁰⁷ Krueger (2002): pp. 30-31.

¹⁰⁸ Kletzer (2003): p. 21.

¹⁰⁹ Eichengreen and Mody (2003): p. 83.

¹¹⁰ Sean Hagan, "Designing a Legal Framework to Restructure Sovereign Debt," *Georgetown Journal of International Law* 36:2 (Winter 2005): p. 323.

mechanism might not be viable for larger countries such as Argentina, which had more than 90 different instruments outstanding.¹¹¹

Sovereign Debt Restructuring Mechanism: Pros and Cons

While the virtue of CACs was minimalism and a lack of intrusiveness in market operations, the proposed Sovereign Debt Restructuring Mechanism (SDRM) sought a comprehensive and statutory approach to restructuring, somewhat analogous to Chapter 11 of the U.S. Bankruptcy Code. While several different versions of the SDRM have been developed, the core "prototype" had five primary features rooted in domestic insolvency laws.

First, at the center of this statutory mechanism would be the Dispute Resolution Forum (DRF), which, upon activation of the SDRM by debtor nations, would be charged with the administrative functions and the resolution of disputes arising in the restructuring process.¹¹² Indeed, at the request of the debtor and upon approval by creditors, the DRF would be empowered to suspend any enforcement actions taken against the debtor.¹¹³ Second, like collective action clauses, the SDRM would allow for qualified majority restructuring provisions.¹¹⁴ However, in contrast to CACs, the SDRM would allow for aggregation of all affected creditor claims (regardless of nature of the instrument) when calculating the approval threshold needed to restructure. However, Anne Krueger was quick to add that safeguards that maintained the seniority structure of claims would have

¹¹¹ Roubini and Setser (2004): p. 7.

¹¹² Kathrin Berensmann and Angelique Herzberg, "Sovereign Insolvency Procedures – A Comparative Look at Selected Proposals," *Journal of Economic Surveys* 23:5 (2009): p. 863.

¹¹³ *Proposed Features of A Sovereign Debt Restructuring Mechanism*, Washington, DC: International Monetary Fund, February 12, 2003: pp. 8-9.

¹¹⁴ Krueger (2002): p. 14.

to be included.¹¹⁵ The Proposed Features of the SDRM recommended a 75% approval threshold of outstanding principal on verified claims as a benchmark for restructuring or implementing a stay on creditor litigation.¹¹⁶

A third distinguishing aspect of the SDRM would be the ability to protect creditor interests. This would occur in two ways. First, the DRF would require the sovereign to provide information on its plans to treat claims that are not to be restructured through the SDRM and to confirm that it was not making payments to non-priority creditors. Second, the DRF would leverage the role of the IMF in ensuring the policies implemented by the indebted country would put it back on the path of sustainable debt service.¹¹⁷ A fourth role of the SDRM would be in encouraging debtor in possession financing by treating any new financing to tide the sovereign debtor through the restructuring phase as senior to preexisting private debt;¹¹⁸ however, as Buchheit, Gulati & Mody have argued, CACs can be used for this same purpose in many cases (26-28).¹¹⁹

Finally, Krueger also examined the role that the IMF more broadly might play in the restructuring process. She noted that countries usually pursue IMF financing in order to avoid restructuring, that this financing is disbursed based on a determination of debt sustainability, and that any such funding is contingent on policy adjustments monitored by the Fund.¹²⁰ Based on these observations, she envisioned a role for the IMF in preventing debtors from abusing the SDRM to escape their repayment obligations. Any activation or request for a stay of creditor action, she argued, must be based on the IMF's verification

¹¹⁵ Ibid., p. 15.

¹¹⁶ *Proposed Features of A Sovereign Debt Restructuring Mechanism* (2003): p. 13.

¹¹⁷ Krueger (2002): p. 16.

¹¹⁸ *Proposed Features of A Sovereign Debt Restructuring Mechanism* (2003): p. 13.

¹¹⁹ Buchheit, Gulati, and Mody (2002): pp. 26-28.

¹²⁰ Krueger (2002): pp. 21-22.

that the sovereign's debt is indeed unsustainable. She also suggested that the IMF should be involved in the approval of a restructuring agreement in order to confirm that it will indeed restore debt sustainability.¹²¹ However, anticipating criticisms of a heavy-handed IMF role, she also laid out an "IMF-light" approach where approval of the restructuring agreement and activation of the stay would be decided solely between debtors and creditors, similar to the restructuring process under CACs.¹²² In such a light-footprint statutory approach, the DRF would only be involved in verification of claims, protection of creditor interests, and facilitation of negotiations.

Several authors have argued that the SDRM might solve the problems of sovereign debt restructuring enumerated above better than CACs. Most obviously, Krueger,¹²³ Eichengreen and Mody,¹²⁴ and Hagan¹²⁵ all noted the ability of the SDRM to aggregate claims across debt instruments. While Krueger admits that viable contractual aggregation mechanisms could be developed she argued that they would be less efficient due to different interpretations across jurisdictions, the inability to force debtors to include such clauses, and the inability to guarantee the integrity of the process through verification of the true value of debtor and creditor claims.¹²⁶ This related directly to Haldane et al and Bolton and Jeanne's reasoning for advocating an SDRM approach. Haldane et al. posited that the benefit of the DRF would be its ability to monitor and provide information to debtor governments and their creditors, thus limiting the strategic bargaining that results

¹²¹ Ibid., p. 23.

¹²² Ibid., pp. 24-28.

¹²³ Krueger (2002): p. 15

¹²⁴ Eichengreen and Mody (2003): p. 81.

¹²⁵ Hagan (2005): p. 336.

¹²⁶ Krueger (2002): p. 32.

in inefficient delays.¹²⁷ Bolton and Jeanne emphasized the issues of inter-creditor equity that give rise to the alleged first mover problem between holders of different bond issues and argue that the SDRM's capability to establish a seniority structure in the aggregation process could help resolve this issue.¹²⁸ Thus, a second source of support for the SDRM was the argument that while CACs solve inter-creditor issues between holders of the same bond issue, the SDRM would also resolve potential inter-creditor group and debtor-creditor collective action problems.

Krueger also suggested that the SDRM would be better able to reduce the uncertainty of the restructuring process and promote a greater level of transparency.¹²⁹ This argument was based on the relative heterogeneity of CACs; as noted above, convergence, especially in different jurisdictions, was viewed as problematic. An international bankruptcy regime for sovereigns might also eliminate asymmetries between countries with CACs and those without. Such a uniform and inescapable (in the sense of being a treaty obligation) mechanism, it was argued, would create incentives for "early and expedited negotiations between the debtor and its creditors."¹³⁰

However, the literature is not short on criticisms of the SDRM; these can be divided in four broad categories. First, several academics argue that a statutory mechanism is politically infeasible and would be "overkill."¹³¹ The Proposed Features notes that the SDRM would be created through an amendment of the IMF's Articles, which would require agreement from 85% of the total voting power. Additionally, since the new treaty

¹²⁷ Haldane et al (2003): p. 24.

¹²⁸ Bolton and Jeanne (2005): p. 37.

¹²⁹ Krueger (2002): pp. 31-32.

¹³⁰ Hagan (2005): p. 346.

¹³¹ Kletzer (2003): p. 21.

obligations would affect the rights of creditors under domestic laws, most countries would need to alter their regulations.¹³² Roubini and Setser thus argue that the “magnitude of the set of problems that can be solved” by the SDRM do not justify the costs of negotiating and imposing a statutory regime.¹³³ Galvis and also Porzecanski argued that the experiences of Ecuador, Pakistan, Russia and Ukraine suggested that market-based restructurings were not necessarily less efficient.¹³⁴ Indeed, both debtor and creditor countries, as well as private sector bodies, appeared hostile to the SDRM proposal. As Galvis observed, debtor countries feared that an SDRM would lead to higher borrowing costs as investors priced in increased risk of default.¹³⁵ The opposition of the financial sector, a key stakeholder in the system, likely influenced opposition in creditor countries, particularly the United States. A related concern in these countries was the concession of familiar and trusted English and New York jurisdiction to the untested supranational DRF during restructuring proceedings.¹³⁶ Indeed, with the United States’ de facto veto power in the IMF, its opposition denied the SDRM proposal the votes it needed in order to be approved by the Fund’s Executive Board.¹³⁷

A second source of criticism was the institutional setup of the DRF. Several scholars and market participants questioned the role of the IMF in the mechanism. Hagan, for instance, suggested that the role of the Fund as a creditor in crises posed an inherent conflict of interest. Even if the IMF Executive Board, which reflects the political interests of

¹³² *Proposed Features of A Sovereign Debt Restructuring Mechanism* (2003): pp. 28-29.

¹³³ Roubini and Setser (2004): p. 11.

¹³⁴ Sergio J. Galvis, “Sovereign Debt Restructurings – The Market Knows Best,” *International Finance* 6:1 (2003): p. 151; and Arturo C. Porzecanski, “A Critique of Sovereign Bankruptcy Initiatives,” *Business Economics*, January 2003: p. 41.

¹³⁵ *Ibid.*, p. 151.

¹³⁶ Hagan (2005): p. 392.

¹³⁷ Jacklin (2010): p. 185.

members, were eliminated from any direct influence in the operation of the DRF, the IMF could still exert influence through its traditional financing decisions. Indeed, it could effectively force a country into invoking the SDRM by denying it financing.¹³⁸ Berensmann and Herzberg took this critique a step further by suggesting that the DRF itself might be biased towards creditor countries' interests. They pointed to the fact that the DRF's panel of judges would be drawn from a permanent pool that would in turn be selected by representatives chosen by the IMF's Executive Board. They also noted that the DRF's independence would likely be compromised by the fact that it would have no authority to challenge decisions made by the Executive Board, including over policy conditionality and debt sustainability.¹³⁹ This could result in an inconsistent mechanism, since the DRF's administration of the technical aspects of restructuring could be hampered by the Executive Board's political financing decisions.

The process of aggregating the sovereign's debt, and defining the scope of debt to be included, proved to be a third source of concern. Hagan noted the inherent tension between inclusiveness and the excessive complexity that comprehensiveness entails. He argued that one risk of such aggregation was that a minority of creditors of one type of claim could be bound by a majority of creditors of a very different instrument. Alternatively, if a qualified majority vote in each class of debt were required, each creditor group would obtain veto power. He also returned to the theme of creditor seniority and inter-creditor equity, observing that unlike in domestic liquidation laws, there is no *a priori* classification system for sovereign debt instruments for the purposes of voting.¹⁴⁰

¹³⁸ Hagan (2005): p. 345.

¹³⁹ Berensmann and Herzberg (2009): p. 863.

¹⁴⁰ Hagan (2005): pp. 347-49.

Finally, the fourth category of criticism was the applicability of the domestic insolvency analogy to the sovereign arena. Galvis noted that both Chapter 11 and Chapter 9 bankruptcies are inapplicable in the sovereign context. Certain key features of Chapter 11, such as the ability to impose changes in management, redirect uses of the debtor's assets to satisfy claims, and regulate debtor actions, retain no meaning when applied to sovereign nations.¹⁴¹ Additionally, while Krueger deemed Chapter 9, which applies to the bankruptcy of municipalities, as a more appropriate basis for comparison,¹⁴² Galvis suggested that the similarities are still limited. In particular Chapter 9 does not apply to states or even counties, but only to municipalities, which must first receive the permission of their governing states before invoking Chapter 9 protection.¹⁴³ Given that there is no higher authority than the sovereign state, the checks on spurious invocation of the SDRM would be limited. Hagan provided a particularly incisive criticism of the domestic insolvency analogy in his observation of the role of liquidation laws in domestic insolvency proceedings. He noted that corporate rehabilitation proceedings operate within a broader set of rules, notably the threat of liquidation, whereby if restructuring fails, a company's assets are liquidated and distributed between creditors.¹⁴⁴ As has been asserted many times in the literature, such liquidation is not applicable to sovereign states.¹⁴⁵ The sovereign state, then, would have no need to fear such consequences and thus may not negotiate with the same earnestness.¹⁴⁶

¹⁴¹ Galvis (2003): p. 150.

¹⁴² Krueger (2002): p. 12.

¹⁴³ Galvis (2003): p. 150.

¹⁴⁴ Hagan (2005): p. 341.

¹⁴⁵ Sedlak (2004): p. 1487; Roubini and Setser (2004): p. 3.

¹⁴⁶ Hagan (2005): p. 342.

Thus, it appears that, at least in the theoretical sense, neither solution has commanded a clear-cut victory. While CACs were advocated as market-friendly, and have become in practice widely acceptable, they have been criticized as inadequate to truly address collective action and aggregation problems in sovereign debt crises. While the SDRM has the potential to be far more comprehensive, the excessive complexities, likely political distortions involved, and explicit surrender of sovereignty it entails have made it impossible to gather a consensus in its favor.

CAC vs. SDRM and the ESM

The ESM's insolvency procedure combines several aspects of contractual and statutory mechanisms for sovereign debt restructuring. On one hand, by mandating collective action clauses, it creates a somewhat decentralized ex ante procedure for renegotiation. In this sense, the criticisms of CACs discussed previously become relevant to assess potential weaknesses in the proposed mechanism. But on the other hand, the ESM creates a substantial statutory presence requiring treaty amendment, the maintenance of a potentially large staff, including high-level political appointees, and control over a sizable emergency fund. In this sense, the critique of the SDRM becomes applicable; much like the IMF, the ESM could face questions about its ability to provide an efficient neutral forum for debt renegotiations since it also acts as a creditor to sovereigns facing balance of payments crises. This section thus applies the CAC vs. SDRM debate to the ESM's debt restructuring component in order to assess the strengths and weaknesses of its particular mix of contractual and statutory approaches.

How Relevant are CAC Criticisms?

The previous exploration of collective action clauses revealed four main pitfalls of this approach; a useful question is whether the ESM's use of CACs suffers from similar flaws. The first criticism, that there is a lack of convergence in CAC terms, can be rejected as inapplicable since member states are legally obligated to introduce "identical and standardized" CACs. The second criticism, related to the uniform adoption of CACs, will remain an issue for some years. While Euro-area members are required to include CACs in all new debt beginning July 2013,¹⁴⁷ debt issued until that date will likely not have these provisions; Buchheit, for example, notes that current Greek debt does not include CACs.¹⁴⁸ Moving beyond the current crisis, in which the ESM cannot play a major role, the mechanism may still face challenges in mandating that an insolvent member states enter into renegotiation with creditors until some years after 2013, since the restructuring-friendly CACs will initially only apply to a small proportion of countries' outstanding debt.

The third problem is that CACs, while addressing inter-creditor coordination problems through qualified majority restructuring provisions, purportedly do not address issues of strategic bargaining between debtors and creditors. The ESM's role as a monitoring institution and a creditor has the potential to ameliorate the information asymmetries that hamper effective negotiations. Making any ESM priority-financing contingent on good-faith negotiations establishes incentives for the borrowing country to negotiate fairly. As a creditor, the ESM would more closely monitor the borrowing country's policies to maximize the likelihood of repayment. Given countries' ability to

¹⁴⁷ Term Sheet on the ESM, European Council, March 24/25, 2011, p. 31, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf>.

¹⁴⁸ Lee C. Buchheit and G. Mitu Gulati, "How to Restructure Greek Debt," Mimeo, May 7, 2010: p. 2.

obscure their actions from market participants, as Greece did in the current crisis, this more rigorous oversight could be reassuring to private sector creditors involved in the restructuring.

However, this incentive structure faces two key limitations. First, the ESM's preferred creditor status means that its lending would effectively subordinate private sector creditors, which could reduce their chances of on-time repayment and could result in lower recovery values.¹⁴⁹ Second, the ESM's debt sustainability analysis may be inherently politicized; the ESM may be loath to declare a country's debt as unsustainable and remand it to restructuring if much of that debt is held by institutions in important creditor member-states. For example, in the current crisis, Buchheit notes that German and French banks have the highest exposure to Greek debt.¹⁵⁰ As such the determination of illiquidity vs. insolvency, which is central to the ESM's operation, may not be seen as credible.

The final, and most serious, criticism of CACs was their inability to effectively aggregate sovereign debt, since they apply only to individual bond issues. The ESM's collective action clauses would contain aggregation clauses that would allow a supermajority of bondholders across bond issues to "include a majority action clause where the needed majority of creditors for the restructuration [*sic*] would not be attained within a single bond issue."¹⁵¹ However, as noted earlier, aggregation clauses only apply to bonds issued within a particular jurisdiction. Yet this does not present a serious obstacle

¹⁴⁹ Emma Ross-Thomas, "Portugal, Greece Ratings Downgraded by S&P on Debt-Restructuring Concerns," Bloomberg.com, March 29, 2011, available at <<http://www.bloomberg.com/news/2011-03-29/portugal-greece-ratings-downgraded-by-s-p-on-debt-restructuring-concerns.html>>.

¹⁵⁰ Buchheit & Gulati (2010): p. 1.

¹⁵¹ Term Sheet on the ESM, European Council, March 24/25, 2011, p. 31, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf>.

for EMU countries. As Choi, Gulati, and Posner¹⁵² and Buchheit¹⁵³ observe, a vast majority of euro-area member state debt is issued under local law (90% for Greece). To the extent that these countries can continue to issue debt under domestic law after the present crisis, the ESM's CAC aggregation clauses should impact a sizable portion of a borrower's debt.

Thus, the ESM incompletely addresses the shortcomings of CACs. On one hand, it does ensure uniformity in the terms and, eventually, in adoption (though its efficacy will be limited for several years), and does not face major issues of aggregation. Yet on the other hand, as a preferred creditor, it may reduce the funds available to private investors, while as a supranational entity, its debt sustainability determinations may be perceived as driven by political concerns of constituent states rather than fundamentals. As such it may not effectively resolve debtor-creditor coordination problems since it may not be seen as a neutral forum. One final challenge going forward in ensuring the predictability of CACs in Euro area member states' debt is judicial treatment arising from any disputes. Because so much of the member states' sovereign debt is governed by their own domestic laws, there is potential for diverging precedents in the interpretation of certain clauses in national courts. While the ESM framework anticipates this and suggests that CACs be "introduced in a standardized manner [to] ensure that their legal impact is identical in all euro-area jurisdictions," how exactly this can be achieved is not clear.¹⁵⁴

¹⁵² Stephen J. Choi, Mitu Gulati, and Eric A. Posner, "Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism," *John M. Olin Law and Economics Working Paper* 541 (November 2010): p. 2.

¹⁵³ Buchheit & Gulati (2010): p. 2

¹⁵⁴ Term Sheet on the ESM, European Council, March 24/25, 2011, p. 32, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf>.

How Relevant are SDRM Criticisms?

Given the possible politicization of the ESM briefly mentioned above, one must consider the broader question of whether creating a supranational statutory entity will increase the predictability and efficiency of debt restructurings. It is in light of this question that it becomes helpful to consider the four major criticisms of the SDRM approach detailed earlier. Two of these can be dismissed immediately, and serve to underscore a fundamental difference between the SDRM and the ESM. First, the literature is critical of the excessive complexity involved in aggregating and defining the scope of the debt under any SDRM restructuring. Second, as discussed above, several authors have noted the inapplicability of domestic insolvency analogies at the sovereign level, particularly given the lack of a sovereign liquidation law. However, the ESM does not have to wade into the mire of trying to develop a priority structure for a country's debt, nor does it draw from domestic insolvency proceedings because it is *not* a supranational bankruptcy court, as the SDRM was envisioned to be. There is no DRF made up of judges to preside over restructuring negotiations, and any aggregation that takes place is limited to those bonds with CACs containing aggregation clauses.

However, it is still appropriate to call the ESM a statutory mechanism even if it will not maintain a heavy-handed role in restructuring because, like the SDRM, it will have to be created by treaty amendment. Thus, concern about the political feasibility of this institution is justified. Indeed, fresh from the painful process of approving the Lisbon Treaty, ratifying the proposed amendment to Article 136 to allow for a permanent crisis resolution mechanism could be an arduous process. However, since Article 136 is a provision in Part Three of the Treaty of the Functioning of the European Union, the ESM amendment would

be subject to a simplified revision procedure. Rather than the usual convening of an intergovernmental conference to formulate the amendment, the ESM changes could be enacted by a unanimous decision of the European Council, though each member state would still have to approve the change according to its constitutional requirements.¹⁵⁵ This fast-track process, while not fully alleviating concerns about the political will, nonetheless makes the process somewhat more efficient.

The institutional structure of the SDRM was a particular concern for many scholars, sovereign issuers, and especially investors, who viewed the IMF's role in the process with understandable suspicion. The role of the ESM in facilitating debt renegotiations is similarly ambivalent. On one hand, certain aspects of the ESM could limit politicization of the debt restructuring process. Because the ESM does not have a direct role in debt renegotiations, the kind of potential conflict of interest that plagued the IMF with respect to the DRF may be somewhat ameliorated. Additionally, both the European Commission and the ECB, which play integral roles in determining debt sustainability, negotiation programs with borrowers, and monitoring compliance, already have an accepted statutory role in policing member state policies; the ESM does not radically expand or politicize their competences.

On the other hand, two areas of the institutional setup could still potentially pose problems for the ESM. First, the process of debt sustainability analysis may be flawed. As Charles Wyplosz observes, because the future is unknown, debt sustainability assessment is only as valid as the underlying assumptions about baseline and stress test scenarios turn

¹⁵⁵ Article 1(56) Lisbon Treaty, *Official Journal of the European Union* 306:39 (December 17, 2007).

about to be.¹⁵⁶ Since the choice of these scenarios is to some degree unavoidably arbitrary *ex ante*, the determination of debt sustainability may not be fully reliable. Forcing a country to restructure based on potentially incorrect assumptions could thus be undesirable.

Debt sustainability assessments may also be inherently politicized due to the impact of restructurings on creditors in key Eurozone countries. Decisions by the Board of Governors and the Board of Directors to approve aid packages are made by a qualified majority of 80%, with votes being weighted by each country's subscription. Under this arrangement, both France and Germany (with 20.4% and 27.1% of the total share of capital) would have effective veto powers, which could reduce predictability based on the political pressures faced by each country.¹⁵⁷ Even though the nominally more independent Commission is delegated the direct role of negotiating, recommending and monitoring economic adjustment programs, the Board of Governors and the Board of Directors may still have some scope to interfere. Consider the relationship between the IMF Executive Board and management as an analogous case. As Ngaire Wood notes, similar ideological mindsets and internal politics often prevent managers from recommending policies that major creditor countries represented on the Board would likely disapprove of.¹⁵⁸ While the relationship between the ESM and the European Commission is in many ways different, this insight that calculations of political feasibility influence even technical negotiations

¹⁵⁶ Charles Wyplosz, "Debt Sustainability Assessment: The IMF Approach and Alternatives," *HEI Working Paper* #03/2007, Geneva: Graduate School of International Studies, December 2005: p. 25.

¹⁵⁷ Term Sheet on the ESM, European Council, March 24/25, 2011, p. 34, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf>.

¹⁵⁸ Ngaire Woods, "The United States and the International Financial Institutions: Power and Influence within the World Bank and the IMF," Chapter 5 in Foot, MacFarlane, and Mastanduno (eds.) *US Hegemony and International Organizations*, Oxford: Oxford University Press, 2003: p. 107.

could plausibly apply to Commission recommendations about debt sustainability that are brought to the ESM's Board of Governors.

The second problem is the actual involvement of the IMF in the ESM. Euro area member states are individually members of the IMF and thus have the right to access IMF financing in the event of a crisis. In order to avoid situations where IMF and European lending may work to contravening purposes (for example, a European country going to the IMF if it is rejected by the ESM), the ESM framework emphasizes close cooperation with the IMF "both on the technical and the financial level."¹⁵⁹ However, the IMF is a global institution with a heterogeneous membership of non-Euro area states. It will thus be interesting to note the degree of burden sharing between the IMF and the ESM both financially and in relation to policy conditionality should the preferences of non-EU actors and the ESM member countries diverge. However, such disagreement has not manifested itself thus far in EU/IMF loans to Greece and Ireland, so this concern may not be serious.

Thus, from a statutory perspective, the ESM opts for a "light footprint" approach. It avoids the SDRM criticisms related to the excessive complexity of aggregating debt and translating domestic insolvency models to the sovereign level by leaving the actual debt renegotiations to be conducted through contractual CACs. While the process of amending the Treaty to establish this new statutory body may be problematic, the simplified revision procedure under the Lisbon Treaty ameliorates this concern to some extent. However, as with the DRF, the institutional structure of the ESM remains a valid concern. Though relying on nominally independent European institutions with entrenched monitoring roles

¹⁵⁹ Term Sheet on the ESM, European Council, March 24/25, 2011, p. 26, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf>.

is helpful, the ESM's debt sustainability analyses could be marred by the political pressures faced by the member states that fund this supranational institution.

Conclusion: Cautious Optimism

For as long as the euro has been around, there have been pundits and scholars who have predicted its downfall. In 1999, for example, Milton Friedman wrote that he was “very negative about the euro and...very doubtful about how it will work out.”¹⁶⁰ More than a decade into its existence, the euro area faces a crisis that has starkly revealed the problematic relationship between, on one hand, a monetary straitjacket imposed by the common currency, and on the other, a de facto loose fiscal constraint which has forced the financial markets to impose the discipline that Eurozone institutions were politically unwilling to enforce. Without the ability to devalue or engage in expansionary monetary policy, the highly indebted PIGS countries (Portugal, Ireland, Greece, and Spain) are faced with painful economic contractions to resolve their imbalances. A key lesson from these crises is that the economic woes of one Eurozone country can become a problem for other member states perceived to be equally reckless. Thus, the movement to establish a permanent mechanism to resolve sovereign debt crises reflects not just a desire to “bail out” individual countries and their creditors, but stems from a realization that the collapse of one country in the absence of adequate tools to resolve its economic difficulties could spell the long predicted doom for the common currency that has been a building block of Europe's economic prosperity and stability.

With the stakes so high, then, examining the viability of the EMU's proposed crisis resolution mechanism is particularly relevant. The quantitative and qualitative

¹⁶⁰ Martino (2010): p. 263.

investigation of this paper suggests the euro area will survive this crisis and may be better equipped to handle such financial troubles better in the future. The ad hoc EFSF mechanism may have initially reduced the movement of 10 year bond yields for Greece, Ireland, and Portugal, suggesting a positive market reaction to the liquidity assistance offered through this mechanism. However, bond yield levels have risen as of late, as the financial markets have increasingly priced in a growing default risk; unless confidence is soon restored, we may yet witness a self-fulfilling prophecy.

Applying critiques of two prevalent methods of sovereign debt restructuring, collective action clauses and sovereign debt restructuring mechanisms, to the proposed European Stabilization Mechanism provides grounds for cautious optimism. The ESM navigates the fine line between the patchwork approach of CACs and the centralization of the SDRM. By leaving the actual restructuring to be conducted through the aggregation of CACs, it avoids problems of defining the scope of the debt and dealing with the problematic translation of domestic insolvency proceedings to the sovereign level in the absence of sovereign liquidation laws. However, by creating a system of monitoring and oversight over negotiations, it attempts to solve problems of debtor-creditor coordination.

However, the Achilles' heel of this mechanism remains the interaction between an inherently politicized institutional structure and the crucial determination of debt sustainability that governs whether a country must restructure. While the ESM tries to limit politicization by delegating the actual examination of sustainability and the negotiation of adjustment programs to established institutions in the European surveillance framework like the European Commission and the ECB, as a supranational body it may not be able to fully ignore the political pressures faced by its member states.

Thus, while the ESM could play a constructive role in establishing predictability in future sovereign debt crises in the Eurozone, this capability can only truly be realized to the degree that European policymakers limit the overt politicization of ESM decision-making; inconsistency in the application of the ESM would only worsen the economic costs and systemic risks of sovereign crises to the Eurozone.

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