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Sovereign Bankruptcy in the European Union

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Zusammenfassung

Anfang 2010, nachdem die Finanzkrise schon überwunden schien, überraschte Griechenlands drohende Insolvenz die Europäische Gemeinschaft. Die mögliche Staatsinsolvenz eines Mitgliedstaates stellte ein ganz neues Dilemma für die Europäische Union dar. Die Bedenken wuchsen, dass die Griechenland Krise der Wirtschafts- und Währungsunion nachhaltig schaden könnte und letztendlich auf die anderen PIIGS Länder überspringen würde. Schon zu Beginn der sich abzeichnenden Krise mussten die Regierungschefs der europäischen Länder feststellen, dass der gerade reformierte Lissabon Vertrag keine geeigneten Instrumente bot, um die wachsende Bedrohung zu bekämpfen. Nichtsdestotrotz mussten Maßnahmen ergriffen werden, um Griechenland zu stabilisieren. Die EU schnürte ein finanzielles Rettungspaketfür Griechenland, welches die Konsolidierung des griechischen Haulshalts ermöglichen sollte. Mit dem Bailout für Griechenland und dem Verstoß gegen Art.125 AEUV setzte die EU einen folgeschweren Präzendenzfall. Die Staatengemeinschaft signalisierte, dass der Bailout eines Mitgliedlandes zur üblichen Praxis werden kann und verschlimmerte somit das „Moral Hazard Problem“. Moral Hazard liegt vor, wenn die Akteure sich durch Vorliegen einer Versicherung unvorsichtiger verhalten, als sie es sonst täten. Es bezieht sich, im Kontext der Staatsinsolvenz, auf die risikoreiche Kreditvergabe von Gläubigern an finanzschwache Mitgliedstaaten. Gläubiger wissen, dass im Insolvenzfall die EU als Bürge einspringtund die Schulden übernehmen wird. Somit sinkt das Risiko für die Gläubiger. Spätestens seit Irlands Insolvenzkrise ist deutlich, dass die Griechenlandkrise kein Einzelfall geblieben ist. Um zu verhindern, dass die EU sich zu einer Haftungsgemeinschaft entwickelt, ist es essentiell ein geeignetes Verfahren zu entwickeln, um mit Insolvenzkrisen von Mitgliedstaaten umzugehen. Wichtig zur Reduzierung des Moral Hazard Problems ist es, das Risikos für Gläubiger und Schuldner zu erhöhen. Nur so kann die risikoreiche Kreditvergabe von Gläubigern und die unnachhaltige Kreditverwendung von Schuldnerländern bekämpft werden. Nach überwiegender Meinung der Fachliterature ist die Lösung ein Insolvenzverfahren für Staaten.

Nach eingehender Literaturrecherche ist festzustellen, dass ein effektives Staatsinsolvenzverfahren folgende Elemente enthalten muss: (i) Gläubigerstillstand, (ii) effektive Anreize, um die Moral Hazard Problematik für Gläubiger und Schuldner zu reduzieren, (iii) Mindeststandards für die Gewährleistung von grundlegenden Staatsfunktionen sowie (iiii) eine unabhängige Instanz zur Koordinierung des

Staatsinsolvenzverfahren.[1] Basierend auf diesen Kernelementen werden drei Vorschläge zur Handhabung von Staatsinsolvenzen analysiert. Der erste Vorschlag stammt vom ehemaligen US Finanzminister John B. Taylor und beeinhaltet die Einführung von Collective Action Clauses (CACs) in die allgemeinen Schuldpapiere. Der zweite Vorschlag wurde von Anne Krueger, der stellvertretenden Generaldirektorin des Internationalen Währungsfonds (IWF), veröffentlicht. Sie schlägt die Schaffung eines Sovereign Debt Restructuring Mechanism (SDRM) vor. Der dritte Vorschlag stammt von Gros und Mayer und erläutert die Schaffung eines Europäischen Währungsfonds (EWF). Die Analyse ergibt, dass zum jetzigen Zeitpunkt keiner der Vorschläge politisch umsetzbar ist. Kruegers Vorschlag scheiterte an der Sperrminorität der USA, der Gebrauch von CACs ist noch zu begrenzt und ihre verstärkte Verbreitung würde viele Jahre dauern. Der Vorschlag zur Schaffung eines EWF ist noch zu unausgereift und lässt wesentliche Kernelemente, die für ein effektives Staatsinsolvenzverfahren sind nötig wären, unberücksichtigt.

Nichtsdestotrotz beeinhalteten sie interessante Elemente, die Teil einer Europäischen Lösung werden könnten. Speziell der EWF Vorschlag nutzt die Maastricht- Kriterien als Grundlage um Defizitsünder frühzeitig zu erkennen und zu finanziellen Abgaben zu zwingen. Diese Abgaben werden dem EWF zugeführt und als finanzielle Basis für zukünftige Stabilisierungspakete genutzt. Auf diese Weise könnte ein effektiver Präventionsmechanismus innerhalb der EU geschaffen werden. Im Fazit folgt die Erkenntnis, dass die EU nachhaltige Reformen durchführen muss, um den neuen Herausforderungen gerecht zu werden. Eine Möglichkeit wäre das Konzept zur Schaffung eines Europäischen Währungsfonds, mit wirksamen Elementen des Krueger Vorschlags zu verbinden. Auch wenn die Reformierung der momentanen Strukturen ein langwieriger Prozess sein wird, ist es doch deutlich, dass (i) die momentane Vorgehensweise der EU zur Stabilisierung von insolventen Mitgliedstaaten ineffektiv ist und die Wahrscheinlichkeit erhöht, dass die EU sich zu einer Haftungsgemeinschaft wandelt, (ii) die aktuellen Überwachungs- und Warnsysteme der EU ineffizient sind und verstärkt werden müssen und (iii) muss die EU einen Weg finden um Schulden effektive umzustrukturieren. Nur wenn Versagen möglich gemacht wird, kann die Disziplin des Marktes wiederhergestellt und Moral Hazard reduziert werden. [2]

[1] See: Schäfer, 2010
[2] See: Gros, D. and Mayer, T., 2010

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List of used abbreviation

CAC	Collective Action Clauses
CDS	Credit Default Swap
DRF	Dispute Resolution Forum
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMF	European Monetary Fund
ESM	European Stabilization Mechanism
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
PIIGS	Portugal, Ireland, Italy, Greece, Spain
SDRM	Sovereign Debt Restructuring Mechanism
SPV	Special Purpose Vehicle
TFEU	The Treaty on the functioning of the European Union
UAC	Unanimous Action Clause
VAT	Value Added Tax

1. Introduction

In the beginning of 2010, right in the aftermath of the financial crisis, Greece had to declare it's almost insolvency. It introduced a complete new dilemma to the European Union: Sovereign Bankruptcy of an EU member state. Early enough, Europe's political leader had to realize that the new Treaty of Lisbon failed to provide the necessary instruments to tackle the growing threat. The general opinion was to save the insolvent state regardless of costs and effort. Bigger was the fear for the impact Greece's bankruptcy might have on the economical and monetary system. Soon the fear, that the bankruptcy could generate spillover effects and threatens other financial destabilized member states (referred to as PIIGS[3]), spread. The EU agreed to establish a financial support program for Greece. It is interesting to see that even though sovereign bankruptcy is not a rare phenomenon[4], the international system lacks a debt restructuring system that is recognized under international law. It seems that especially in an economical union like the EU, in which countries tie their economies closely together, a procedure to efficiently manage a sovereign bankruptcy is sorely missed.

1.1. Thesis Objectives

Through the study of relevant theories, literature reading and comparison, this thesis gives an insight into the development of the Greek crisis and its impact on the EU. Further it critically analyzes the field of managing sovereign bankruptcy. A focus of the thesis is to compare the current proposals about how to tackle the problem of sovereign debt restructuring. Since these proposals are mainly made in the global context, an underlining focus would be to analyze whether the proposals would be suitable as a base for a European debt restructuring mechanism. Different authors argue that the European Union as a unique supranational entity might have the competence to implement a binding sovereign bankruptcy procedure for its member states. The EU might have the necessary sanctions mechanism to enforce compliance with procedures and therefore might succeed where the IMF failed. The first objective is to analyze the Greek crisis. What is identified are the circumstances which led to the Greek almost insolvency and the general development of the crisis. In this context the EU rescue program will be elaborated and the impact these

[3] Portugal, Ireland, Italy, Greece and Spain
[4] Mexico in 1994, Russia in 1998, Argentina in 2002 (et al.)

measures had on the European Union. The second objective is to identify why a sovereign bankruptcy procedure is necessary. The purpose is to create a fundamental understanding. Hence this part focuses on the explanation of fundamental terms and concepts linked to sovereign bankruptcy. Further it is necessary to identify the main disincentives threatening the process of debt restructuring. To complete the understanding of a sovereign bankruptcy procedure, an outline of the current coordination of sovereign debt restructuring will follow. The third objective is to specify which requirements a sovereign bankruptcy procedure needs to fulfill in order to correct or reduce possible disinvites. This ideal-typical approach creates a necessary frame of reference to compare the three current debt restructuring proposals. Included in the comparison is the proposal by Taylor (former Under Secretary of Treasury for International Affairs of the U.S.A.) suggesting implementing Collective Action Clauses (CAC's). The assistant director of the IMF, Anne Krueger, made the second proposal in November 2001. She proposed the implementation of a Sovereign Debt Restructuring Mechanism (SDRM). A comparison of those proposals will highlight the significant differences. The last proposal, recently made by Gros and Mayer, concerns the creation of a European monetary fund (EMF). The proposal promotes the idea that the EU should seek an independent, EU- suitable solution to tackle sovereign bankruptcy of EU member states. Subsequently the thesis will consider to which degree the three proposals are compatible to serve as a solution on EU level. The thesis will conclude with a summary of the main findings.

2. The Greek crisis

The almost insolvency of Greece highlighted a new dilemma in the Euro Zone. Greece's struggle to cope with increasing national debts and the threat of insolvency proved not to be a single case scenario. Several member states of the European Union referred to as PIIGS (Portugal, Ireland, Italy, Greece and Spain) are endangered to suffer the same fate as Greece almost did. It is of interest to observe the past developments of the PIIGS states with special emphasis of Greece. Their membership in the European Union, their economic performance and their management of national debts draw an appropriated picture about how a state insolvency can occur.

2.1. The development of the Greek financial crisis

Critics argue that the accession of the PIIGS States to the European Monetary Union initiated the process which finally led to the now occurring crisis. The European Union as well as the new member states put emphasis on resolving the economic deficit between the poorer new member states (Ireland '1973, Greece '1981, Portugal and Spain '1986) and the richer western countries.[5] To achieve the economical and social convergence the European Union initiated a cohesion program which included financial aid varying between 1.5 percent and 3.5 percent of the BIP and even surmounted the 4 percent mark temporarily.[6] The subsequent economical boom in the cohesion countries was not only influenced by the massive financial support the countries received from the EU. Supporting factors was on the one hand the low wage level that attracted increasing capital inflow and on the other hand, the membership in the Monetary Union which resulted into declining capital market interest rates. This led to the complete approximation of interest level within the Monetary Union, enabling investors in the cohesion countries to refinance themselves to very beneficial conditions.[7] One explanatory factor for the decreasing nominal interest rate is according to Apolte that the no-bailout clause, included in the Treaty of Lisbon, lacked credibility. Hence an additional risk premium on the state securities is unnecessary since creditors did not expect that in the case of states insolvency the EU would refuse to guarantee for the concerned country.[8] According to the rules and standards of the Stability Pact seemed the idea of a sovereign insolvency unthinkable. The Maastricht Criteria which allows a maximum new indebtedness of 3 percent was only met by Greece due to systematic data fraud. Once being in the Union, Greece continued to breach the 3 percent barrier.[9] However, the low interest rates stimulated Greece to a rising use of credits. New indebtedness has been used to master the debt service for the past debts. This system (referred to as snowball system) was temporally successful due to the particular situation of Greece.[10] The interest rates for state securities in Greece have been nearly continuously lower than the nominal GDP growth rate. As long as the growth rate of the total debt is equivalent to the growth of the interest rate, which is lower than the nominal GDP growth rate, will the debt level as percentage of

[5] See: Delhey, 2002
[6] See: Delhey, 2002
[7] See: Lammers, 2010, p. 17
[8] See: Apolte, 2010, p. 10
[9] See: Otte, 2010, p. 147
[10] See: Apolte, 2010

the GDP decline.[11] These facts explain why it was possible for Greece to continuously breach the Maastricht Criteria concerning the new indebtedness level while its debt level in percentage of the GDP even slightly decreased. We might say that this procedure was functioning as a very effective debt brake but evidently lacked sustainability. [12] The low interest rates increased the transfer of cheap money into the country. The government expenditures soared and the Greek economy experienced a massive boom. Especially the real estate branch and construction industry profited from the rising investments.[13] Although the economy grew, the government failed to solve the issue of the inefficient public sector with its excessive wages and kept losing competiveness.[14] Consequently, the external current account deficit in the end of 2009 was above 11 percent of the GDP, the net international investment position exceeded negative 83 percent of the GDP, and inward direct investment was low.[15]

The economical and financial crisis occurring in the beginning of 2007, stressing the European economy, was the pivotal external effect causing the collapse of the Greece state finance system. What was left, resulting from increasing spending and a loose expense discipline, was a deficit of 13.6 percent of the GDP and a public dept of 115 percent of the GDP in 2009.[16] Even though Greece was not the only member state which got highly affected by the crisis but nevertheless was the first one to almost reach the status of illiquidity. One reason might be the market's lack of trust that Greece may be capable to adopt the needed fiscal consolidation measures. Rating agencies downgraded government bonds, and investors started to sell Greek bonds, driving up their yields.[17] The result was that risk premiums for Greek state securities rose up to 4 percent.[18] Furthermore, within this period the nominal GDP growth rate declined considerably and even fell below the nominal interest level which resulted into a rising debt position.[19] This initiated a spiral shaped development in which state debts and risk surcharges continuously escalated.[20] Finally, it was uncertain

[11] See: Apolte, 2010, p. 9
[12] See: Apolte, 2010, p. 10
[13] See: OECD, 2010
[14] See: OECD, 2010
[15] See: Greece—Memorandum of economic and financial policies, 2010, p. 1
[16] See: Greece—Memorandum of economic and financial policies, 2010, p. 1
[17] See: Greece—Memorandum of economic and financial policies, 2010, p. 1
[18] See: Hefeke, 2010, p. 3
[19] See: Apolte, 2010, p. 10
[20] See: Konrad, 2010, p. 143

whether Greece would be able to raise enough money on the capital market to ensure their debt service for April and May 2010 and therefore would have officially reached the point of insolvency.

If the Euro fails, (...) fails Europe and then fails the Idea of the European unification.[21]

The global economic crisis had severe effects on Greece and was now about to threaten the so commonly solid European Monetary Union. The fear that the euro would go down in value spread over Europe. After Greece announced their corrected budget deficit and the rating agencies downgraded the credit ratings of state securities, the pressure on the Share Price Performance of the Euro increased.[22] The EUR/USD dropped from 1.50 to 1.36.[23] During the critical period of the crisis the euro experienced severe price fluctuation. In June the Euro exchange rate fell on its lowest value since four years to 1.20.[24] The impact of Greece's default on the euro stability might be overestimated argue economists. After all, the Greek economy only generates 2.7 percent of the EU's economic output and is therefore too weak to be a definite threat to the euro. Nevertheless, the threat of creating spillover effects was and is very apparent.[25] The euro zone faced the risk that the debt crisis would cause that the investors' lack of trust may spill over to other weaker member states like Portugal, Spain or Ireland. It was well established that the further PIIGS states were struggling with high debt levels and an increasing budget deficit as well at this point (see Table 1). The creditors' lack of trust would have a direct effect on the capital market and initiate a further wave of increasing risk premiums and interest rates for PIIGS states. The possibility of these states to achieve cheap refinancing on the capital market would massively decline. Finally, liquidity shortage of these countries would increase and worsen their current financial crisis. The increasing uncertainty forced the political leader of the EU to take action. With the implementation of the rescue package for Greece, as well as with the establishment of the European Stabilization Mechanism (which will be explained in the following paragraph) the danger for the other PIIGS states is not yet relativized but the euro exchange rate returned to a rather normal level. Nevertheless, specialists agree that the

[21] Quote: Kämpfer für Europa, 2010, p. 1
[22] See: Hefeker, 2010
[23] See: Euro/ Dollar Kurs, 2010
[24] See: Euro/ Dollar Kurs, 2010
[25] See: Otte, 2010

threat to the euro is not the price fluctuation but the loss of trust in the stability of the currency.[26]

Table 1: Performance of PIIGS states

PIIGS States	Greece	Portugal	Ireland	Italy	Spain	**For comparison:** Germany
Debt level **in percentage of GDP 2009**	115,1	76,8	64,0	115,8	53,2	73,2
Budget deficit **in percentage of GDP 2009**	13,6	9,4	14,3	5,3	11,2	3,3
Unemployment rate **in percentage of GDP 2009**	10,2	10,5	13,2	8,8	19,1	7,3
Due government bonds **Till the end of 2010, in billion Euro**	16,2	17,5	8,6	228,5	75,2	232,7
Government bonds yield **5 years duration, in percentage**	13,0	5,7	4,5	3,2	3,7	1,7
Rating **By Agency: Standard & Poor's**	BB+	A-	AA	A+	AA	AAA

Source: Eurostat, Bloomberg[27]

[26] See: Euro/ Dollar Kurs, 2010
[27] See: Balzli, B.; Kurgjuweit, D.; Mahler, A. et al., 2010

2.2.Greek support Program

In the spring of 2010 the EU agreed on co-ordinate bilateral contributions for Greece in the amount of €110 billion lasting from 2010 till 2012. The calculated amount is supposed to cover the prognosticated new debts of probably 45 billion euro which will arise in the time span. Additionally ca. 50 percent of the repayment and interest rates of estimated 112 billion euro shall be paid by the EU relief fund. 80 billion euro of the contributions have been provided by the EU where as 30 billion originated from IMF credits.[28] The beneficial financial support is granted at a reasonable rate of interest. The interest rate is about 4 percent annually, with 3 repayment-free years.[29] These co-ordinated bilateral contributions agreed upon by Greece, IMF, EU and the ECB is linked to a memorandum of understanding which determines a list of requirements which have to be fulfilled according to a strict time schedule in a period lasting from 2010 to 2014.[30] Government expenditures will be reduced by 7 percent of the GDP. The measurements to achieve this aim will be a direct cut in the labor costs of the public sector, and in pension outlays. Revenues will be raised by around 4 percent of the GDP. This will be achieved by increases in the VAT[31], higher taxation on petrol, consumption of alcohol, and tobacco. Next to direct cost- cutting measurements the EU and IMF committed Greece to severe structural reforms. Long required reformations of the pension – and health care system shall be implemented, the tax system as well as the tax administration will be closely revised.[32] Especially the review and the technical support of the administration system are, according to analysts, crucial.[33] The memorandum clarifies that the departments responsible for the public financial management, the fiscal framework and the debt management framework have to be closely monitored and supported. These changes intend to strengthen the control over revenues and expenditures and establish an efficient and transparent administrative system.[34] Finally, the central idea of the memorandum is to achieve a GDP deficit reduction from 13.6 percent to 8.1 percent within 2010. Further revenue and expenditures measures aim for a deficit reduction of 4 percent of

[28] See: Meyer, 2010
[29] See: Meyer, 2010
[30] See: Greece—Memorandum of economic and financial policies, 2010
[31] Value Added Tax
[32] See: Greece—Memorandum of economic and financial policies, 2010
[33] See: Meyer, 2010
[34] See: Greece—Memorandum of economic and financial policies, 2010, p. 9-10

the GDP in 2011, 2.8 percent in 2012 and 2.6 percent in 2013.[35] If the financial support is able to prevent the Greek sovereign default, is based on a number of different assumptions. The cost-cutting program imposed on Greece has to function and the economy is only allowed to slow down within an expected range. Finally, a positive development is dependent on the medium-dated evaluation of Greece solvency by the capital markets.[36] Only if Greece consolidating measures are convincing will the interest rate for their state bonds decrease and facilitate Greece's refinancing on the capital market. The financial rescue package has been created outside the negotiations concerning a permanent solution for further threatened EU Member States.[37]

> *"In the wake of the crisis in Greece, the situation in financial markets is fragile and there was a risk of contagion which we needed to address. We have therefore taken the final steps of the support package for Greece, the establishment of a European stabilization mechanism and a strong commitment to accelerated fiscal consolidation, where warranted."*[38]

In the beginning of May the EU member states adopted an European Stabilization Mechanism (ESM) to alleviate the impact of the economical and financial crisis and to preserve the fiscal stability in Europe. Legal basis of the implemented mechanism is the Art. 122.2 of the Treaty as well as an intergovernmental agreement of euro area member states.[39] According to the framework of the mechanism, countries with liquidity shortage and impending sovereign bankruptcy receive credit support. The credit amount is a compound of two sources of capital. 60 billion euro are available via the European Stabilization Mechanism based on Art. 122.2 TFEU and originates from the EU budget. Additionally to the ESM the EU member states established a special purpose vehicle (SPV) called European Financial Stability Facility (EFSF) which ensures loans up to an amount of 440 billion euro.[40] The financial resources provided by the EFSV will be raised in the capital market. The collective of the member states will act as warrantor for the loans, the Interest

[35] See: Meyer, 2010, p. 2
[36] See: Meyer, 2010, p. 2
[37] See: Sinn, 2010, p. 3
[38] Quote: The Council of the European Union, 2010, p. 6
[39] See: The European Stabilization Mechanism, 2010
[40] See: The European Stabilization Mechanism, 2010

rates generated by this procedure have to be covered by the beneficiary country.[41] A compulsory condition is that all EU member states, the ECG and the IMF agree upon the fact, that the country in question is indeed affected by an impending sovereign bankruptcy. An agreement is reached if the IMF detects an increasing insolvency and approves the cost-cutting program of the affected government.[42]

2.2.1. The Effects of the Greek support program

After the introduction of a three year package to stabilize the fiscal situation in Greece, the crisis was not overcome. The international capital market still remained skeptical. After all, the financial support secured solely the claims of the creditors, while the debt level of Greece continued to be unaltered.[43] It is necessary to understand that the rescue package functions as a transitory finance. The central aim is to prevent the imminent insolvency of the country.[44] Hence it is a time-limited measure which provides Greece with more time to undertake the necessary steps to consolidate their budget and decrease their new indebtedness rate to a level which will stabilize the debt level. [45] Only if the measures proof to be efficient and sustainable will the level of risk premiums decrease and the country will regain the trust of the market. The current situation allows only limited assumptions about whether the rescue package of the IMF, EU and ECB will work. In the end Greece has to proof that their proposed structural reforms and cost-cutting measures will be efficient and are sufficient to achieve the consolidation of its national budget.[46] At this point it seems interesting to consider the signal effect which the EU bailout has on the international capital markets.

2.3.Consequences for the EU

The implemented measures to prevent a Greek default create a set of different problems. With the approval of the Greek rescue package in May 2010 as well as the decision to establish a European Stabilization Mechanism to support defaulting EU member states the EU created an instrument for institutionalized bailout. The established procedure can be seen as a clearly infringement of Article 125 of the TFEU. The article represents a no bailout

[41] See: Sinn, 2010, p. 3
[42] See: The European Stabilization Mechanism, 2010
[43] See: Schnellenbach, 2010
[44] See: Schnellenbach, 2010
[45] See: Schnellenbach, 2010, p. 4
[46] See: Schnellenbach, 2010

provision, clarifying that members of the Monetary Union will not be liable for the payments of debts of other member states.[47] The principle of the provision is to guarantee that states are responsible for the repayment of their public debts. A not sustainable fiscal policy should not lead to the transfer of risk premiums to other member states of the Union. The clause shall encourage a sound fiscal policy and eliminate an irresponsible and risk-entailing national fiscal policy.[48] The financial rescue package for Greece can therefore be regarded as a breach of the European Constitution. The EU proofed with the infringement that they do not regard the articles of their constitution as irrevocable. Therefore the general credibility of the EU might be in question.[49] Hence, possible sanctions of the EU imposed for inadequate implementation of the cost-cutting programs in Greece will be considered as incredible and will lack a sufficient deterrent effect.[50] A second problem is that the Greek bailout constitutes a precedent with grave consequences. One aspect is that member states which are threatened by sovereign default in the future, will expect financial support based on the precedent the Greek bailout set in the euro zone; leaving the EU with no choice but to bail for the debts. This might transform the European Union from a mutual support group to a transfer union.[51] Despite the effect the Greek crisis might have on other countries, the signal effect it has on creditors and debtor country might be even more severe.

2.3.1. Moral Hazard

The current EU approach to handle the bankruptcy of Greece and Ireland inevitably provokes a problematic stimulation of the bankrupt state as well as the private creditors. If the players can rely on the fact that in the case of doubt the EU will agree to a bailout, the creditors are more likely to approve high-risk credits.[52] At the same time, the debtor country will not refrain from an excessive borrowing nor will it seek a more cautious budgetary policy, since the expected EU bailout will preserve the countries access to the capital market. Therefore functions the EU as an insurer for both parties. The risk, that a player will behave less cautious because of the existence of insurance is called Moral Hazard.[53]

[47] See: Kämmerer, 2010
[48] See: Glossar, 2010
[49] See: Schnellenbach, 2010
[50] See: Schnellenbach, 2010
[51] See: Schnellenbach, 2010
[52] See: Kemming, 2007
[53] See: Kemming, 2007, p. 22

The literature divides between a Moral Hazard that occurs on the side of the debtor, created through the protection granted by the expected financial support and Moral Hazard on the side of the creditor, which occurs if a protection against severe payment default exists.[54] Literature agrees that Moral Hazard caused by a possible EU or IMF bailout has a bigger impact on creditor behavior than on the behavior of the debtor. The explanation is that even though a debtor state can rely on an IMF bailout, it is still obligated to implement a strict cost cutting program and repay the IMF loan. Further, its debt amount will not be reduced, whereas creditors, in the case of an IMF bailout, get the full amount of their loans repaid. Comparing the effects of a bailout it seems obvious that they do not unfold a sufficient disciplinary effect for creditors but might succeed to discipline debtors.[55]

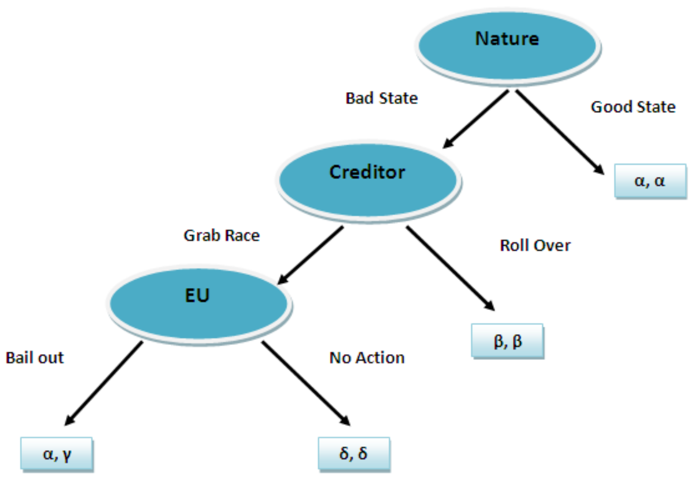
2.3.2. Why do bailouts occur?

If the EU creates an institutionalized process to handle possible state bankruptcies of their member states it is important to consider which course of action the creditors might take within a possible debt restructuring process. A game with two players (the EU and the debtor versus the creditors) will help to explain why the bailout option is more likely than an extension of credits by creditors.[56] The starting situation is confirmed financial difficulty of a sovereign. With the start of the negotiations about possible support programs or debt restructuring, several course of actions emerge for creditors. One option is to extend the terms of their credits or alternatively they could try to sell their credits on the capital market.[57] Miller and Zhang, on whose assumptions this scenario is based, point out three options creditors have: The "free rider option" refers to creditors who will not participate in the debt restructuring procedure and thus try to find a way to requisite their total claims at a later date. A further scenario includes the "rush to the court house" in which creditors try to assert their claims in court and with this behavior possibly block the debt restructuring procedure. The last scenario is the "rush to the exit" scenario in which creditors would predict the possible crisis and sell their bonds as fast as possible.[58] The entirety of the options of action is known as "grab race". The grab race is one of the major problems within a state bankruptcy. Close inspection reveals that this behavior harms the creditors as

[54] See: Kemming, 2007
[55] See: Kemming, 2007
[56] See: Kemming, 2007
[57] See: Miller, M.; Zhang, L., 2000
[58] See: Miller, M.; Zhang, L., 2000

collective. It reduces the funds of the debt state even further and leads inevitably to a worsening of the crisis.[59] Even though Miller and Zhang refer in their scenario to the IMF as the second essential player, it is in the case of this thesis convenient to focus on the European Union as the more influential actor. Therefore, as second player the EU has two options. It could as in the case of Greece agree to perform a bailout or decide to take no action. Both sides are fully aware about the procedure and possible actions.[60] Further, it is necessary to observe the external economic factors. A global financial crisis already creates a negative initial situation and has a direct effect on the amount of the expected payment for the creditor.[61] The highest disbursement in the amount of α for both actors can be expected when the general economic situation is good. In a negative economic situation the creditors may tend to roll over their credits, which would lead to a payment in the amount of β for both actors. If the creditors do not roll over and a grab race between the different creditors start, the behavior of the EU is essential. The EU has two options: bailout or no action. If the EU agrees on a bailout the creditors receive the highest payment in the amount of α and the debtor of γ. In the case that the EU decides to take no actions both actors receive the lowest payment in the amount of δ. To illustrate the different decisions and outcomes, it is convenient to use a game tree.

Figure 1: Game tree: Interaction between creditors and debtor



[62]

[59] See: Kemming, 2007
[60] See: Miller, M.; Zhang, L., 2000
[61] See: Miller, M.; Zhang, L., 2000
[62] Game tree. Source: Miller, M.; Zhang, L., 2000, p. 353

Miller and Zhang argue that the dilemma linked to a bailout is that the EU's refusal to grant the debtor financial support lacks credibility.[63] The international market knows that certain countries are "too big to fail" without creating massive ripple effects throughout the EU system. The EU, in order to minimize the damage for the euro area, will most likely (as the Greece and Ireland crisis proved) agree on a bailout for the affected country. This creates the creditor attitude to always choose the option grab race. This choice will ensure him the highest possible outcome (α) since he can rely on the EU bailout.[64]

2.4. Conclusion: Why a European Solution might be necessary.

The current development proved that the sole membership in the European Union will not reduce the insolvency risk of states. Vivid examples are Greece and Ireland. Further the control mechanism of the Stability and Growth package proofed that it is incapable to monitor the budget development of Member States fully and correctly and therefore failed to notice that Greece was facing a sovereign bankruptcy. Secondly the effectiveness of the current sanctions mechanism is questionable. Especially if a countries budget crisis is mainly affected by a global crisis a monetary penalty, the condemnation as "deficit-sinner" and the stop of payments from the structural fond might be rather counterproductive.[65] Finally, the recent EU measures to prevent a sovereign default of their member states (Greece and Ireland) aggravate not only the issue of Moral Hazard but also include the risk that the no bailout provision of the Lisbon Treaty will be ultimately invalidated. This might turn the EU from a mutual support group into a transfer union, creating wrong incentives for creditors and debtors. As long as creditors can expect a bailout (the full repayment of their loans), they will not stop lending money to debtors who follow an irresponsible and risk-entailing national fiscal policy.[66] Literature agrees that a sovereign bankruptcy procedure can successfully tackle the issue of Moral Hazard. Moreover, the recent crisis within the EU is a strong signal that the EU legal framework does not provide the right instruments to tackle sovereign default sufficiently. The EU's approach of handling the Greece almost insolvency generates a set of wrong incentives for creditors and debtors. Economist *Nouriel Roubini* argued in an interview with "*Der Spiegel*", that: *"the financial support program for Greece solely pushed the problem in the next year. (…) To invest money in an insolvent country while*

[63] See: Miller, M.; Zhang, L., 2000
[64] See: Miller, M.; Zhang, L., 2000
[65] See: Schäfer , 2010, p. 10
[66] See: Kemming, 2007, p. 23

implementing strict financial and political restrictions (…) will not resolve the situation. We need a Plan B. We need to obtain a solution between creditors and debtors, in an orderly procedure. (…) If such a Plan B will not be developed soon, the threat of a domino effect emerges. Then the crisis will spread to countries like Portugal and Spain. This would eventually mean the collapse of the euro."[67]

[67] Quote: Schulz, T.; Jung, A., 2010, p.73

3. The necessity of a bankruptcy procedure for sovereign states

After elaborating the development and effects of the Greek crisis, the focus of the following paragraph is to gain an insight into the general term of sovereign bankruptcy. This part attempts to answer the question whether a sovereign state can go bankrupt. Further, a definition of sovereign bankruptcy will be introduced and the major coordination problem while restructuring sovereign debts will be outlined. Finally the paragraph will present the current coordination of sovereign debts via the Paris – and London Club.

3.1. Definition and explanation of sovereign bankruptcy

The previous paragraph lined out the critical situation of Greece as well as their almost-bankruptcy. Without the financial support of the EU Greece would have failed to service its debts. This imposes the question: Can a state go bankrupt? Under private law it would be impossible for a state to go bankrupt. Based on its sovereign position, a country can use legal mechanism in order to fulfill its obligation. It could increase taxes, decrease public expenditures or sell resources. If the creditors of the sovereign debtor extend the term of payment combined with the state's compliance with a strict cuts plan the state would be able to generate enough financial resources to amortize its debts and prevent a bankruptcy.[68] However, the population's acceptance level for broad expenditure cuttings and increased tax burden is limited. States can only use this instrument to some degree without threatening the political stability of the country.[69] Hence, history bears a vast number of examples of sovereign debt crisis beginning with Mexico in 1994, Russia in 1998 and Argentina in 2001.[70] In an approach to define sovereign bankruptcy in a broad term it is possible to state, that "*a sovereign state is bankrupt if it fails, in whole or in part, to service its debts or interest payments. (…) A state bankruptcy can become apparent if bank deposits are compulsory frozen or if deposits in foreign currency get compulsory exchanged in the national currency*".[71] Determining if a state is facing bankruptcy or is already bankrupt is complicated. Beck and Wentzel suggest using the level of external debts as a benchmark. One indicator is the relationship between export earnings and debts. As long as a national

[68] See: Kemming, 2007, p. 5
[69] See: Abberger, 2010, p. 36
[70] See: Eichengreen, 2003, p. 75
[71] Quote: Abberger, 2010, p. 37

economy can repay its external debts with their export earning it is not threatened by insolvency. Further indicators are the relation between foreign exchange reserves and foreign exchange outflow as well as the relation between debt level and the countries national product.[72]

In the event of a sovereign financial crisis it is essential to understand that debts are not equal debts. They can be segmented into internal debts and external debts. External debts are debts towards foreign creditors and are not subject to national law. Internal debts are debts towards national creditors, in the national currency and subject to national law.[73] The currency of the debts is of significant importance. If a sovereign state has a high amount of internal debts, listed in his own currency, it could service its debts by printing more money. This way the level of inflation would increase and the value of the debts would decline.[74] This option is only possible if the sovereign state has control over its national currency. In the case of Greece this option is blocked by its membership in the EMU, in which the ECB controls the euro. Nevertheless, in several cases in which states faced bankruptcy the crucial factor was their failure to service its debts in foreign currencies. Beck and Wentzel point out that it is not an irrevocable fact that all external debts are listed in a foreign currency. The external debts of the USA or of member states of the EU are mainly listed in their own currency. Other countries often fail to convince foreign creditors to keep debts in the countries national currency due to the risk that they might depreciate their currency to devaluate the debts.[75] A further interesting differentiation is whether the financial crisis could be distinguished as a temporary liquid shortage or a long range insolvency problem. In the case of a temporary liquid shortage the country is generally solvent but due to high short term liabilities it struggles to generate enough liquidity to repay the liabilities. The temporary liquid shortage can be tackled by receiving an accommodation credit from the IMF or another country.[76] If the financial crisis is based on a long range insolvency is then the problem solution is more difficult. In this case the sovereign state, due to its high debt level, is insolvent. Without implementing a strict cost cutting program the country will fail to

[72] See: Beck, H., Wentzel, D ., 2010, p. 169
[73] See: Beck, H., Wentzel, D ., 2010, p. 36
[74] See: Beck, H., Wentzel, D ., 2010, p. 37
[75] See: Beck, H., Wentzel, D ., 2010, p. 37
[76] See: Beck, H., Wentzel, D ., 2010, p. 38

reduce its debts.[77] At this point the important role of the creditors starts. If the creditors lack trust in the success of the countries cost-cutting program they might decide to increase the risk premiums for the concerned country. This will have a direct effect on the level of refinancing costs which will inevitably result in an increasing debt level. The final outcome is a debt spiral. Nevertheless, reasons for bankruptcy can be various. It can be triggered by political disturbance, war, natural catastrophes or macroeconomic deficits (e.g. if a country has a low economic growth while having relatively fixed exchange rates).[78]

3.2.Coordination problems of debt reorganization

In the case of a sovereign insolvency massive coordination problems emerge. Especially the debt restructuring of state bonds is, due to the heterogeneity of private creditors, linked to severe problems. The higher the heterogeneity of creditors, the more complicated their coordination in a debt restructuring procedure is. The variety of creditors includes private and small creditors as well as public and institutionalized creditors (e.g. pension funds).[79] Throughout the restructuring procedure of state bonds three issues of collective action may arise: the free riding problem, the rush to the exit, and the rush to the courthouse. The free riding problem implies that a possible debt restructuring, which is beneficial for the majority of creditors, is blocked by a minority of creditors (free riders). This behavior blocks a swift debt restructuring. The trigger for this behavior is that the minority has an incentive not to participate in the restructuring procedure since they assume that they are able to claim the entire amount of their demands after the official restructuring procedure is completed.[80] The rush to the exit can be unleashed as soon as creditors fear that the sovereign state is threatened by insolvency. This phenomenon occurs before the restructuring procedure begins. In this case they try to sell their long term liabilities and try not to extend their short term liabilities. Rush to the exit implies that it is important to be faster than the other creditors, because only the first few will get a sufficient high price for their liabilities. This rush inevitably leads to a depreciation of the specific state bonds on the financial market.[81] This behavior can initiate the debt spiral mentioned before. A depreciation of the state bonds causes increasing risk premiums, which results in growing refinancing costs which will

[77] See: Beck, H., Wentzel, D ., 2010, p. 38
[78] See: Beck, H., Wentzel, D ., 2010, p. 37
[79] See: Berensmann, K.; Herzberg, A., 2007
[80] See: Berensmann, K.; Herzberg, A., 2007
[81] See: Kemming, 2007

compound the financial crisis.[82] The rush to the exit can have such a severe impact that even a short term liquid shortage can result into an acute debt crisis, especially if the sovereign state has a high amount of short dated debts.[83] The final issue of collective action is the threat of rush to the court house. Similar to the rush to the exit, this takes place before the official restructuring starts. It implies that some creditors consider their final outcome better when they try to initiate (as soon as possible) a lawsuit against the defaulting country. If they are one of the earliest plaintiffs it increases their chance to receive the full amount of their liabilities. Negative effect of the rush to the courthouse is the soaring number of lawsuits which results into a depreciation of the state bonds. The probability that a private creditor can successfully claim the full amount of its liabilities in the court is low. In general the process of claiming the liquid assets of a state is a time consuming and complicated process, especially since sovereign states are better protected in court than a private creditor could be.[84] The two threats of the rush to the exit and the rush to the courthouse can be referred to as the creditors grab race.[85]

3.3. Current coordination of debt restructuring

Public creditors (official government agencies, sovereign states) coordinate the rescheduling of their debts on an ad hoc basis, known as the Paris Club.[86] The beginnings of the Paris Club dates back to the year when Argentina agreed to negotiate with its public creditors in Paris in 1956. Since then, the Paris Club has reached 421 agreements with 88 different debtor countries.[87] The Paris Club holds its meetings in Paris chaired by a representative of the French government. The Paris Club is an informal panel in which the procedural rules are determined by a consensus of the creditor countries.[88] A threat arising from this procedure is that a major creditor country is able to block negotiations if it serves his interest. The debt restructuring procedures bases on a set of fundamental principles: Individual case consideration, consensus principle, the principle of solidarity between the creditors of the

[82] See: Kemming, 2007, p. 24-25
[83] See: Kemming, 2007, p. 25
[84] See: Kemming, 2007, p. 25
[85] See: Kemming, 2007, p. 26
[86] See: Hudes, 1985
[87] See: Club de Paris, 2010
[88] See: Bundesministerium für Wirtschaft und Technologie, 2010

Paris Club and the principle of conditionality[89].The latter principle refers to the obligation of the debtor country to implement the IMF adjustment program in order to improve the national economic and financial situation. [90] The IMF occupies the position of an observer. Its profound knowledge of the economical and financial situation of the concerned country contributes to the negotiation of the creditors and its forecast of balance of payments influences the volume of the debt restructuring significantly.[91] The outcomes of the negotiations are mainly extensions of loan durations, a reduction of interests or a partial debt relief. Additionally the IMF grants financial support to restore the solvency of the debtor state in order to preserve the countries access to the international capital market.[92]

Supplementary to the Paris Club, a second panel got established: the London Club in 1976. The objective of the panel is to coordinate the debt restructuring of private banks (banks or other commercial lending institutions).[93] Contrary to the Paris Club, the London Club does not maintain a permanent meeting place. In the event of a debt default forms a group of creditor banks the Banking Advisory Committee. Compared to the Paris Club, the volume of debt restructuring in the Londoner Club is lower. The bottom line is that especially public creditors and multilateral financial institutions (IMF etc.) have to absorb the main financial burden. Private creditors are neither included in the debt restructuring procedure of the Paris Club nor the London Club. This means that the main beneficiaries of an IMF bailout are the defaulting country and the private creditors.

[89] This term describes a concept used in different sectors of development aid, international relations or political economy. It refers to certain conditions which are attached to a loan, debt relief, bilateral aid or membership of international organizations (IMF, OECD, WTO etc.). (Gabler Wirtschaftslexikon, 2010)
[90] See: Bundesministerium für Wirtschaft und Technologie, 2010
[91] See: Deutsche-Bundesbank, 2003
[92] See: Bundesministerium für Wirtschaft und Technologie, 2010
[93] See: Lanz, 2011

4. A corporate Bankruptcy procedure

After considering the threats to an effective debt restructuring procedure in the previous paragraph it seems plausible to continue with the examination of the major objectives and requirements which have to be fulfilled by a corporate bankruptcy procedure.

4.1. The Objectives of a corporate bankruptcy law

Bankruptcy law is a legal process which will determine the steps of an individual or entity in the case of a financial crisis. Basically, it tries to find a compromise between the right of the creditor to receive its rightful repayment, including interest and the legal principle that the fulfillment of a contract can only be required if it will not cause an unacceptable situation for the debtor.[94] It is possible to divide the insolvency proceedings in two phases, each of them having a different objective, which are: ex ante objectives and ex post objectives.[95]

4.1.1. Ex ante objectives

Next to determining the obligatory actions in the event of a bankruptcy, different authors argue that a further and very important function of the bankruptcy law is its preventive effect.[96] The existence of a bankruptcy law should have a significant effect on the actions of creditors and debtor before the financial crisis even occurred. It should create an incentive to creditors to reconsider the hazardousness of their credits since a possible bailout should not be the main motivation to grant a credit to an entity which lacks the needed financial strength to repay these credits.[97] Additionally the bankruptcy law should reduce the raising of unnecessary credits, bring a stop to reckless borrowing by countries and force the debtor to use the credits for important and useful projects.[98] Essential to this effect is the threat of punishment. Only if the bankruptcy procedure is linked to severe punishments for the actors will it fully develop its preventive effect.[99] In the current procedure guided by the IMF the financial support is linked to a strict cost-cutting program which the country has to adhere

[94] See: Kemming, 2007
[95] See: Kemming, 2007, p. 7
[96] See: Kemming, 2007, p. 8
[97] See: Kemming, 2007, p. 8
[98] See: Kemming, 2007, p. 8
[99] See: Kemming, 2007, p. 8

to. Further, the creditors have to expect a partially haircut, reducing the amount of the expected credit repayment.[100]

4.1.2. Ex post objectives

The ex post objectives focus on the effects which an efficient bankruptcy law has to create after the insolvency has already occurred. The target is to manage the debtors' asset as good as possible. Unlike an insolvent company, it is not possible to dissolve the assets of a sovereign state in order to repay the creditors demands.[101] Therefore, the only possible ex post strategy is to initiate a debt restructuring procedure while creating the best possible conditions for the running economic performance.[102] Although there is a consensus about the need of debt restructuring, achieving a consensus about the optimal debt restructuring approach seems to be a complicated affair. Nevertheless, in order to resolve a financial crisis of a sovereign country it is essential to develop a set of regulations to put a stop to erratic creditor actions and facilitate taking swift actions.

4.2.Requirements for a corporate bankruptcy law

A systematic procedure to manage a sovereign bankruptcy should include five requirements to ensure the successful restructuring of the sovereign debts. It should ensure the equal treatment of creditors (par conditio creditorum), enforce a standstill of payments and litigation, include effective incentives for creditors and debtors to decrease the issue of moral hazard, determine minimum standards to ensure basic government functions and give a detailed outline of specific procedure provisions.[103]

The coordination of creditors is a key element to the success of a debt restructuring procedure. Due to the increased globalization of the financial market the amount of creditors grew as well as their diversity, complicating their coordination in the restructuring process.[104] By combining the heterogeneous creditors into one equal group it might be possible to tackle the coordination problem. Kemming lines out that only if the creditor can be certain to be treated equal will the free riding problem be prevented.[105] To increase the

[100] See: Kemming, 2007, p. 8
[101] See: Kemming, 2007, p. 9
[102] See: Kemming, 2007, p. 9
[103] See: Schäfer, 2010, p. 19
[104] See: Schäfer, 2010, p. 20
[105] See: Kemming, 2007, p. 14

participation of creditors in the restructuring procedure, it is advisable to initiate a total standstill after the government of the debt state announced bankruptcy. The standstill concerns on one hand a stay of all litigations, so that creditors are incapable to claim their demands in court. On the other hand a total standstill refers to a suspension of payments to any creditors (payment moratorium).[106] According to Kemming the effects of the standstill are that no creditors will be treated beneficial because they were the first to claim their demands in court. This will hinder them to start a grab race. Furthermore a standstill will prevent a depreciation of the existing assets which can occur if a large amount of bonds will be sold in a short period (flight of capital). Therefore it could be an efficient instrument to preserve the countries asset.[107]

Contrary to Kemming, Roubini and Setser point out that if creditors of short-term bonds expect that the defaulting country will initiate a standstill, they will rush to extract their demands before the country is able to impose the standstill. Hence, the expectation of a standstill could be a trigger for a grab race instead of a barrier.[108] Even though there are opposed opinions about the efficiency of a standstill, it remains an important element in the debate about efficient debt restructuring and is included in Krueger’s proposal for a sovereign debt restructuring mechanism.

The second element focuses on incentives a bankruptcy law can generate. An efficient bankruptcy law should fulfill the ex ante and ex post objectives elaborated in part 4.1. Creditors should refrain from careless lending and debtors should avoid unreasonable application of funds.[109] Literature argues that by applying a haircut, creditors will receive reduced interest payments and have to accept a write down of their loans.[110] This way they are forced to back the cost of a bankruptcy procedure and they will consider the hazardousness of their lending policy in the future. Debtors will be disciplined by the threat to be subject of a strict cost cutting program and close supervision by international organizations (EU and/ or IMF). Both entities have to participate in the cost of a sovereign bankruptcy.[111] This is the only way to tackle the moral hazard issue.

Further, a corporate bankruptcy procedure should clarify general procedure provisions.

[106] See: Schäfer, 2010, p. 19-20
[107] See: Kemming, 2007, p. 15
[108] See: Roubini, N.; Setser, B., 2004
[109] See: Kemming, 2007, p. 22
[110] See: Schäfer, 2010
[111] See: Kemming, 2007, p. 23

These should include a set of criteria which determine whether a country fulfills the facts of insolvency; it should outline which entity is entitled to coordinate the restructuring process and which entity shall initiate the procedure?

Finally, a corporate bankruptcy procedure should consider that even though a strict insolvency procedure is necessary to create a sufficient deterrent effect for the debtor, it is crucial to establish a minimum standard which is essential for the preservation of basic government functions. The aim is to ensure that the lifestyle of the population will not fall below a specific level. [112] The access to basic social transfers and public commodities must be maintained; otherwise civil commotions might increase and hence threaten the political stability of the affected country. The determination of essential government functions is rather complicated; Schäfer suggests using Chapter 9 of the US Insolvency Code and civil rights as an orientation to create a sufficient norm.[113]

Situations in the past have proven that all of these elements are necessary to increase the chance and the incentives to realize efficient debt restructuring.[114]

[112] See: Schäfer, 2010
[113] See: Schäfer, 2010
[114] See: Miller, 2002

5. The organization of a corporate bankruptcy procedure

After elaborating the major objectives and requirements, which have to be fulfilled by an efficient bankruptcy procedure, the next paragraph will focus on existing proposals on how to manage or solve the dilemma of sovereign bankruptcy. The debate that an international bankruptcy procedure is needed is old. A vast number of proposals from different authors were introduced[115]. Nevertheless, the current debate centers on two proposals which pursue a different approach: The "Sovereign Debt Restructuring Mechanism" (SDRM) proposed by First Deputy Managing Director of the International Monetary Fund, Anne Krueger in 2001 and the implementation of "Collective Action Clauses", proposed by John B. Taylor, former Under Secretary of Treasury for International Affairs of the U.S.A. Since the thesis focuses on the dilemma of an insolvency of an EU member state it seems convenient to consider the proposal of establishing an European Monetary Fund (EMF). The proposal was published in a paper by Gros and Mayer in 2010 and generates a new EU focused approach.

5.1.Collective Action clause

Collective Action Clauses (CAC's) are included in bonds in order to facilitate the restructuring of debts. They combine three aspects: Collective representation, majority voting and the sharing clause. A CAC basically specifies who represents the creditors in the case of negotiation. It lines out the details of the majority-voting procedure in order to change the financial terms of the contract and it reduces the chance of individual creditors to exploit lawsuits to delay settlements and to gain additional payments.[116] Finally CAC's ensure that all bondholders share the final repayment equally.[117] This way the start of a grab race shall be prevented. The proposal to intensify the use of CAC'S was made by the Group of ten countries in the echo of the Mexican Crisis in 1994 and further elaborated in a paper by John B. Taylor.[118] The (i) majority action clause within CAC's is of specific importance. The clause authorizes a specified majority, often seventy-five percent of the holders, to engage, on

[115] During the last decade several numbers of proposals were published. The most prominent include the proposal by Schwarcz (2000), development of an international convention for sovereign insolvency procedure, based on the Ch. 11 of the US Insolvency law, the proposal by Raffer (1990) to implement an ad hoc arbitration and the proposal to create an International Debt Framework by Berensman und Schröder (2006)
[116] See: Eichengreen, B.; Mody, A., 2004
[117] See: Kletzer, Kenneth M., 2003
[118] See: Eichengreen, B.; Mody, A., 2004

behalf of all bondholders, in restructuring negotiation with the debtor and other creditors.[119] This procedure is considered as an efficient way of streamlining and simplifying the debt restructuring process.[120] This provision is not a complete innovative approach within international law. CAC's are already included in bonds governed by the law of England and Japan.[121] Taylor further suggests to include a (ii) representation clause, specifying how the creditors will be represented, under which terms a meeting between creditors and debtor will be initiated, which data the debtor has to transfer to the creditors and a broad timeframe in which all these steps have to be accomplished.[122] Further (iii) an Initiation clause should define how the defaulting country can initiate the restructuring process. Taylor points out that a certain amount of time will pass till the first creditor meeting will take place. This meeting is essential and the first time the creditors will get all necessary information, select a representative and decide on how to handle the bankruptcy. Taylor suggests granting a "cooling off period" of 60 days, which will occur between the restructuring announcement of the debtor and the creditor meeting in which they chose their representative. During the 60 days a payment standstill could be established as well as a penalty scale, preventing violations against the time limit or the terms of the payment stop.[123]

Several critics point out that more than two-thirds of current outstanding emerging market debts include Unanimous Action Clauses (UACs), and the majority of them will not end within the next years.[124] To overcome the problem of transition, to a more common use of CAC's, some time will be needed. Allen and Gale (2004) argue that it is essential to conquer the product uncertainty which investors link to the CAC's. Investors do not trust their performance characteristics and are worried that facilitating the restructuring procedure might result in making it a more common solution for sovereign states.[125] This might have an effect on the interest costs for borrowers.[126] A further point of criticism is the problematic coordination across different creditor groups. CAC's are designed to facilitate the

[119] See: Eichengreen, B.; Mody, A., 2004
[120] See: Kletzer, Kenneth M., 2003
[121] See: Häusler, G., Gianviti, F. and Geithner, T., 2003
[122] See: Taylor, 2002
[123] See: Taylor, 2002
[124] See: Kletzer, 2004
[125] See: Allen & Gale, 1994
[126] See: Kletzer, 2004

coordination of bond holder actions of a specific bond issue. But it is very common that countries have multiple bond issues.[127] This would mean that in the transition period only the newly issued bonds will be included in the restructuring. Taylor considered these aspects in his paper and suggests that an aggregation provision could help to guarantee the incorporation of the holders of all bond issues.[128] To accomplish a swift transition it is important to create efficient incentives for the borrowers. Incentives like low interest rates for bonds including CAC's. Additionally, a bailout by the IMF for bonds without CAC's will be refused, this way countries should be encouraged to reclaim issued bonds without CAC's.[129] However, the practicability of these suggestions is questionable. The height of interest rates are formed in the financial market and can hardly be influenced by the IMF or any other organization. Further proved the game tree elaborated in 2.3.2, that it is very unlikely that the IMF will refuse a bailout. Generally Taylor regards a bailout or the interference by the public sector as undesirable. It is interesting to see that Taylor's concept does not explicitly include a haircut; from his point of view matters of debt reduction should be resolved in negotiation between creditors and the debtor. Opposed to the SDRM proposal of Krueger, Taylor's proposal neither includes considerations about protecting the basic government functions to ensure a swift economical recovery of the country nor does it include a reflection about the need of a superior authority to control the negotiations. However, he mentions that the IMF should be engaged to monitor the economic conditions but a further involvement is not elaborated.[130] Even though Taylor's proposal relies heavily on further negotiation between bond holders and the defaulting country, it lacks a mechanism which might force creditors and debtor to come to an agreement. Based on his construct, creditors are able to buy bonds in the secondary market and therefore obtain a blocking minority, putting a stop to further restructuring negotiation.[131] Although the U.S. and EU government have endorsed the inclusion of CAC's in international bonds, they fail to amend security registration requirements and alter rules of their financial system to enable the use of CAC's.

[127] See: Kletzer, 2004
[128] See: Taylor, 2002
[129] See: Taylor, 2002
[130] See: Taylor, 2002
[131] See: Hefeker, 2002

They rather see their task in protecting the investors from fraud and securing the integrity of the markets, than to innovate the international financial architecture.[132]

5.2.Sovereign Debt Restructuring Mechanism (SDRM)

"There is a growing consensus that the present process for restructuring the debts of a sovereign is more prolonged, more unpredictable and more damaging to the country and its creditors than would be desirable. Exploring ways to improve the sovereign debt restructuring process is a key part of the international community's efforts to strengthen the architecture of the global financial system."[133]

In November 2001 the assistant director of the IMF, Anne Krueger, presented a new proposal to manage sovereign bankruptcy. The IMF's endorsement to improve the supervision and regulation of financial systems and developing techniques for identifying looming risks[134] more promptly fueled the debate about the international financial architecture.[135] The result of the IMF efforts was the introduction of the Sovereign Debt Restructuring Mechanism (SDRM). A main objective of the SDRM is to create incentives for a swift and efficient debt restructuring as well as to contribute to crisis prevention and solution.[136] The initiation of the debt restructuring mechanism lies within the responsibility of the defaulting sovereign. Hereby the sovereignty of the country can be preserved. Only if the debt amount can be seen as unsustainable is it justified to initiate the bankruptcy procedure.[137] Krueger points out those mechanisms to prevent misuse initiation of bankruptcy procedure (by minor debt level) are essential.[138] The elements of the SDRM are chosen in a way to protect the creditors during the restructuring process, preventing that none of the creditor will receive a preferential treatment. The basic elements are: (i) standstill and a stay on litigation. A standstill can be activated if the request of the defaulting country is approved by the IMF. The extension of the standstill can only be authorized, for limited duration, by the IMF. If the maximum duration is reached, only the approval of a creditor majority can extend the standstill. The attempt is to prevent a rush to the exit or a

[132] See: Eichengreen, 2003
[133] See: Krueger, 2002, p. 6
[134] See: IMF, 2002
[135] See: Eichengreen, 2003
[136] See: Berensmann, K.; Herzberg, A., 2007
[137] See: Kemming, 2007
[138] See: Krueger, 2002

rush to the court house. Nevertheless, a payment standstill can have severe negative effects on the defaulting country. Payments as trade credits are essential for the continuation of the external trade and therefore should not be stopped. Further, a standstill can damage the image of the sovereign and impede its access to the international capital market in the future.[139] (ii) A supermajority of creditors will be involved in the process of restructuring the payment terms of the debt. The minority of creditors are bound by the vote of the majority. This aspect should be sufficient to tackle the free rider problem.[140] Further, it is desirable to combine the entirety of creditors and bond issues, despite their diversity, into one group. Krueger's approach formulates the need to develop a mechanism that facilitates obtaining new financing during the restructuring procedure. If the country succeeds to invest capital in the right manner, the economic disruption could be reduced and support it generating capital to repay debts.[141] Therefore (iii) preferred- creditor incentives are included. Creditors which provide new money will obtain a preferred creditor status.[142] A last element is (iv) conditionality. Obligatory part of the SDRM is a strict fiscal adjustment program to ensure the fast rehabilitation of the defaulting country's budget, as well as allowing the defaulting country to access the capital market to support the country's economic performance. [143] Krueger's approach primarily refers to private (foreign) creditors. Domestic and official debts are mentioned but how the SDRM will manage them is not furthere elaborated. Krueger suggests that official debts should be handled in the Paris Club as usual. Regarding domestic debts is it important to ensure that the country's banking system stays liquid to guarantee their mediator function between domestic savings and foreign creditors. Further, it is essential to guarantee that the country can mobilize capital from its domestic capital markets since in the period after the restructuring it is very likely that its access to international capital markets will be denied.[144] Problematic might be: if domestic creditors receive a preferential treatment, then foreign creditors might refuse to participate in the restructuring process. Therefore it will come down to the consideration between the efforts to ensure national investments and the extent of the restructuring process.[145] The question

[139] See: Berensmann, K.; Herzberg, A., 2007
[140] See: Bolton, P.; Skeel, D. A., 2004
[141] See: Krueger, 2002
[142] See: Miller, 2002
[143] See: Krueger, 2002
[144] See: Krueger, 2002
[145] See: Krueger, 2002

which institution will coordinate the SDRM was very critical. The major role of the IMF in the first draft arouses massive criticism. In the modified version the power of the creditors was strengthened. A majority of creditors is enabled to decide on a final restructuring plan, the duration of the automatic stay as well as granting new credits with preferred creditor status.[146] In her proposal, Krueger discussed the options that the sovereign can initiate a stay with the approval of the majority of the creditors, or that the majority of creditors are responsible for initiating and extending the stay but the sovereign has the competence to enforce a debt moratorium (unilaterally) for 90 days. [147] Krueger explains, regarding the completion of the SDRM, that with the certification of a valid restructuring agreement by the Dispute Resolution Forum (DRF) the SDRM is automatically finalized. However, the sovereign can, at all times, request to terminate the SDRM.[148] In 2002 the realization of the SDRM failed. The full implementation of Krueger's proposal would have made it necessary to amend the IMF'S Articles of Agreement. To do so requires a majority of 85 percent in the IMF. The support of the U.S. government, which holds 17.1 percent of the votes, was therefore inevitable. Eventually the U.S. government refused to support the SDRM and it is therefore postponed until today.[149]

5.3.Creating a European Monetary Fund

"…in the recent financial crisis, policy has been geared solely towards preventing failure of large institutions. In the future, however, the key policy aim must be to restore market discipline by making failure possible."[150]

In their paper "How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund" Gros and Mayer elaborate the option of creating a EU based mechanism to cope with sovereign insolvency. The authors suggest that the principle of solidarity is not only applied when a member state is in the danger of suffering an orderly default. The idea of the EMF (European Monetary Fund) implies that member states, which incriminate the community, must help to build up financial resources which will be used in the case one member state faces financial issues or even insolvency.[151] The point is that by entering the

[146] See: Berensmann, K.; Herzberg, A., 2007
[147] See: Krueger, 2002
[148] See: Krueger, 2002
[149] See: Eichengreen, 2003
[150] Quote: Gros, D. and Mayer, T., 2010, p. 2
[151] See: Gros, D. and Mayer, T., 2010, p. 2

European Union, the member states accepted that their economies will eventually be highly depending on each other. Therefore problems of one member state can easily spill-over to their fellow member states. The CEPS argues that euro members have the responsibility to avoid causing any difficult situations.[152]

The basic rule of the financing of the EMF is that only those countries that breach the criteria of the Maastricht Treaty have to grant money. The amount of the fine will be calculated as followed (example Greece):

Table 2: Calculation of the EMF fine

1% annually of the stock of 'excess debt'	Actual level of public debt	115%
	- Maastricht limit of public debt	- 60%
+	= Stock of excess debt	= 55%
	(1% of excess debt)	(0,55%)
1% of the excessive deficit	GDP deficit	13%
	- Maastricht limit of GDP deficit	- 3%
=	= Excessive deficit	= 10%
	(1% of the excessive debt)	(0,10%)
Total EMF contribution 2009		0,65%

Data from: (Gros, D. and Mayer, T., 2010)

The CEPS decided to use the Maastricht criteria: Budget deficit and the debt-to-GDP ratio to determine the probability of a default.[153] The benefit is that these indicators are not affected by market speculations, nevertheless recent cases proved that country budget reports (example Greece) were manipulated, leading to the conclusion that the EU has to improve or reconsider their surveillance method. Further, the CEPS argues that not all countries have to pay contributions when violating the Maastricht criteria. Countries with outstanding public finances as Germany for example, are, according to the CEPS, able to handle a possible crisis on their own and therefore don't need to contribute. Additionally, the financial power of these countries will be used as a backup by the EMF.[154]

If we assume that with the start of the EMU[155], the EMF would have become effective as well, the EMF could have accumulated €120 billion in reserves[156]. This would have been

[152] See: Gros, D. and Mayer, T., 2010, p. 2
[153] See: Gros, D. and Mayer, T., 2010, p. 2
[154] See: Gros, D. and Mayer, T., 2010, p. 3
[155] European Monetary Union

enough to cover the first rescue package for Greece of €110 billion lasting from 2010 till 2012 without burdening the EU, the EU relief fund or making use of the IMF credits. The benefit would be that the EU can build up financial reserves in advance and make use of this fund without long lasting and difficult negotiation with the EU leaders. The contributions to the EMF can present a stimulating effect, motivating countries to avoid a breach of the Maastricht criteria's, decrease their Moral Hazard and generally lower their debt level.

In case that a country seeks financial support from the EMF the CEPS presents two possible forms of how to provide it:

> Stage 1:
>
> In the threat of an impending insolvency a country may request access to its own deposit (plus interest) which it contributed to the EMF in the past to pay off its public debt. This is possible as long as the Eurogroup granted the country's fiscal adjustment program.[157]
>
> Stage 2:
>
> If the first amount drawn from the EMF is not sufficient to settle the liquidity risk, a country has the option to request financial support from the EMF on top of its own deposit. This guarantee is linked to the agreement to implement a tailor-made adjustment program monitored by the Commission together with the Eurogroup.[158]

A reason why the EU is considered to be more effective in handling an impending insolvency of an EU member state compared to the IMF is the existence of their enforcement mechanism. In the case that a country does not comply with the goals of the tailor-made fiscal adjustment program the EU can stop any further payment of EMF, to begin with. Further, this payment stop can be extended to the payments of the structural funds, which present a significant financial source for many countries. As a final measure the violating countries' access to the euro area's market can be denied. This is founded on the countries

[156] See: Gros, D. and Mayer, T., 2010, 3. This figure bases on an estimated calculation by the CEPS. It does not consider the likeliness that the existence of the EMF would have had an effect on the debt level of EU member states.
[157] See: Gros, D. and Mayer, T., 2010, p. 3
[158] See: Gros, D. and Mayer, T., 2010, p. 3

debts which are no longer suitable to run parallel to the ECB's repo operation.[159] Important is that these measures cause severe economic and political costs for the violating country and therefore increases their effectiveness.

"Market discipline can only be established if default is possible (…)."[160]

As long as creditors are sure that a default will not be considered by the EU, the risks for the creditor decreases and the Moral Hazard problem increases. The CEPS suggest that the EU should consider a way to manage an orderly default of an EMU country. The first priority is to find a protection against systematic effects of a default. One option to control these effects might be the implementation of an exchange procedure. The general idea is that the EMF offers the concerned debt holders an exchange of these debts. Instead of fighting for their demands against the defaulting country they will transfer them to the EMF and receive payments for them.[161] The debts will not be repaid to 100%. A haircut will be carried out. The EMF might declare that it will invest 60% of the GDP of the insolvent country. In the case of Greece this would have meant that 60% of 120% debt to- GDP ratio would have been covered by the EMF, causing a loss of 50% for the creditors.[162] This way the issue of Moral Hazard on the side of creditors could be tackled. The haircut presents a clean cut. All funds or EU transfer payments that the insolvent country receives after the cut have to be used in accordance with the tailor-made fiscal adjustment program. [163] The EMF proposal does not mention the involvement of private creditors nor considers the aspects of collective representation, majority voting or a standstill. But in order to increase the transparency of the financial markets, the proposal suggests, that the EMF could exchange only obligations traded on open exchange or options that had been previously registered with the department of the EMF, responsible for the verification of public debt figures. This measure increases the risk of secret derivative transactions, since they would not be exchanged by the EMF in case of state failure and makes them less appealing for actors within the financial markets.[164]

[159] See: Gros, D. and Mayer, T., 2010, p. 4
[160] Quote: Gros, D. and Mayer, T., 2010, p. 4
[161] See: Gros, D. and Mayer, T., 2010
[162] See: Gros, D. and Mayer, T., 2010
[163] See: Gros, D. and Mayer, T., 2010
[164] See: Gros, D. and Mayer, T., 2010, p. 5

Finally, the CEPS argue that a well worked out framework for sovereign bankruptcy of an EU member state is essential for the independence and credibility of the European Union. Only by making failure possible can the market discipline be restored and the EU's no bailout clause would regain its credibility.[165]

5.4.Comparative Analysis

The comparison of those three proposals should leave the impression that none of the approaches constitute the perfect solution. Each of the proposals include elements that are specifically strong and elements that need further amendment.

Miller identifies a set of key features which might help to analyze the debt restructuring efficiency of the three proposals. These features are: Stopping a grab race, financing reorganization, restructuring debt and restraining holdouts. To create a sufficient deterrent effect I would propose to include the question to which degree the proposal includes a "punishment" of creditors and debtors.

The SDRM proposal by Krueger complies with the idealistic concept of an efficient debt restructuring procedure the most. It includes a stay of litigation as well as a standstill of payments to tackle the grab race efficiently. It offers a preferred creditor status for the provision of new capital. To coordinate the debt restructuring process, the SDRM proposal refers to an independent entity to supervise the negotiation between creditors and debtors. Further, the proposal is linked to the obligatory implementation of a strict fiscal adjustment program. The free rider and collective action problems are tackled by supermajority voting which binds creditor minorities to restructuring decisions. Even though the SDRM approach constitutes an efficient concept for restructuring sovereign debt the realization in the international system is unlikely. The resistance against the amendment of the IMF'S Articles of Agreement is too powerful to overcome.[166]

The proposal by Taylor includes the initiation clause, to prevent the grab race by delaying payments. The representation clause in the CAC lines out a set of basic rules to coordinate the creditor-debtor negotiation without entitling an independent entity to supervise these. It is questionable if negotiations and debt restructuring under these terms can be successful since no entity can apply pressure to stimulate a favorable outcome. Similar to the SDRM proposal CAC's include provisions for super majority voting, limiting collective action

[165] See: Gros, D. and Mayer, T., 2010, p. 6
[166] See: Eichengreen, 2003, p. 77

problems. The CAC proposal does not include further thoughts about stimulating new capital inflows and therefore fails to manage the financing of the reorganization of the affected country. Moreover, CAC's do not provide a disciplinary instrument as a haircut to force creditors to reconsider their lending practice.

One restriction for the more common use of CAC's is the aggregation problem. CAC's do not sufficiently tackle the issue of creditor diversity and their coordination. A second restriction is the transition problem. CAC's are currently not very common and are only included in new bonds. Therefore, a long transition period is necessary until sovereign debts can be substantially restructured via CAC's.[167]

The EMF proposal by Gros and Mayer fails to consider a vast number of relevant key features. The involvement and coordination of private creditors is not mentioned nor is the aspects of collective representation, majority voting or a standstill, in order to prevent a grab race or to tackle the free rider problem, considered. Gros and Mayer do not elaborate how the reorganization of the insolvent state shall be financed; a preferred creditor status is not mentioned. From this perspective the EMF proposal is still inadequate and requires further development.

Nevertheless, an interesting aspect is that the EMF proposal includes insolvency prevention measures (by punishing the breach of Maastricht Criteria) and lines out how to use EU funds to increase the pressure on the sovereign to enforce compliance with the fiscal adjustment program. Additionally, it includes a strict haircut that will create a sufficient disciplinary effect for creditors and tackle the moral hazard problem.

Finally, the previous analysis of the three proposals clarifies that the proposal by Anne Krueger most closely correspondents to the ideal concept of a debt restructuring mechanism. Nevertheless, the political resistance of the U.S.A successfully prevents its realization.

[167] See: Miller, 2002,

6. Conclusion

Ever since Ireland sought financial aid from the EU and the IMF in the end of 2010, even the optimist had to admit that the Greece financial crisis was not a spectacular and isolated case. The idea that an EU Member State could be threatened by bankruptcy was unthinkable. Nevertheless, Greece and Ireland proved that this assumption is wrong. Now the remaining PIIGS States are in the focus of the international capital markets. The first part of the thesis elaborated the EU's rescue measures. It lined out that with the bailout of Greece the EU created precedence, fueling speculations that an EU bailout will become common practice in order to rescue endangered member states. The EU positioned itself in a very inconvenient way. By signaling that an infringement of Article 125 of the TFEU (no bailout provision) is likely to become an institutionalized measure to tackle the risk of sovereign default, they increased the threat of Moral Hazard. Creditors are aware that even high risk loans to weak EU member states will eventually be secured by the EU. Considering the possibility that financial crisis of EU member states will become more common in the future it is essential for the success of the EU that a different approach to handle sovereign default is found. The EU has to restore market discipline by making failure possible.[168] Even though the Moral Hazard problem can never be fully neutralized, it is important to increase the risk for creditors and debtors to minimize careless lending practice and unsustainable fiscal policy. The third part of the thesis introduced three proposals to handle sovereign bankruptcy. Even though the comparative analysis proved that at the current stage none of the proposals could be effectively implemented, they still offer a set of efficient and interesting measures. The legal impact the EU has on its member states could offer the appropriated framework to create a mandatory and efficient sovereign default mechanism.

The EMF proposal by Gros and Mayer fulfills important ex ante objectives. Especially the suggestion to use the common Maastricht criteria to identify "debt sinners" and link it to the payment of fines into a new created EMF could generate the needed prevention mechanism currently missing in the EU. In order to guarantee the efficiency and reliability of the Maastricht Criteria the EU has to reconsider their monitoring and enforcement mechanism to prevent that other countries will follow Greece's example and hide their solvency problems by lying about their budget deficit. Even though the EMF proposal by Gros and

[168] See: Gros, D. and Mayer, T., 2010, p. 4

Mayer lacked a vast number of relevant key features to ensure an efficient debt restructuring, it still generates the right approach: Tackling the problem of sovereign default on EU level. Inadequacies of the construct could be substituted by elements of Krueger's proposal. An option would be to create an independent European committee (comparable to the Paris Club) which is bound to the legal framework of the EU and coordinates the negotiation between creditors and debtor. Essential elements, which should be abstracted from the Krueger proposal, are payment standstill and a stay of litigation to prevent a drain of capital. Further should incentives for creditors and debtors to tackle the moral hazard problem (haircut and fiscal adjustment program) be implemented and minimum standards ensuring essential state functions to protect the basic rights of affected citizens should be considered. A beneficial aspect is that the EU is equipped with a sanction mechanism, deterrent enough to enforce compliance with the bankruptcy mechanism. By refusing EMF support or further payments from the structural funds, the EU has a leverage that the IMF always missed. A sufficient debt restructuring procedure requires, of course, a broader elaboration. The introduced example is only a vague outline of what should be aimed at. The final realizations should be that the (i) EU's current approach to stabilizing defaulting states needs to be changed to avoid a shift into a transfer union, (ii) a strengthening of the EU's monitoring and warning mechanism to reveal a possible insolvency crisis as soon as possible is essential, (iii) the EU has to find a way of efficiently restructuring debts to prevent careless lending practice and unsustainable fiscal policy. Only if the EU is willing to implement profound reforms, then it will be enabled to manage a future sovereign bankruptcy crisis of a member state successfully and therefore the EU can guarantee a long-term stabilization of the euro.

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Affidavit

I hereby declare that this paper has been written only by the undersigned and without any assistance from third parties.

Furthermore, I confirm that no sources have been used in the preparation of this paper other than those indicated in the thesis itself.

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Münster, 28.02.2011