

Bachelor thesis for the attainment of the degrees Bachelor  
of Science and Bachelor of Arts

# **The European Sovereign Debt Crisis and an orderly insolvency procedure as an alternative remedy**

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## **Plagiarism Declaration**

I hereby declare that the bachelor thesis in hand on the topic

***The European Sovereign Debt Crisis and an orderly insolvency procedure as an alternative remedy***

is the result of my own independent work and makes use of no other sources or materials other than those referenced, and that quotations and paraphrases obtained from the work of others are indicated as such.

Münster in July 16, 2012

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# Abbreviations

<b>CACs</b>	Collective Action Clauses
<b>ECB</b>	European Central Bank
<b>EFC</b>	European Fiscal Compact
<b>EFSF</b>	European Financial Stability Facility
<b>EFSM</b>	European Financial Stabilisation Mechanism
<b>EMU</b>	European Monetary Union
<b>ERM</b>	European Restructuring Mechanism
<b>ESDC</b>	European Sovereign Debt Crisis
<b>ESM</b>	European Stability Mechanism
<b>EU</b>	European Commission
<b>ICSID</b>	International Centre for Settlement of Investment Disputes
<b>IMF</b>	International Monetary Fund
<b>SDRM</b>	Sovereign Debt Restructuring Mechanism
<b>SGP</b>	Stability and Growth Pact
<b>TFEU</b>	Treaty on the Functioning of the European Union

# 1. Introduction

In January 2011 the *Gesellschaft für Deutsche Sprache* (Own translation: Society for German Language) chose the word "*alternativlos*" (In English: *without any alternative*) to be the ugliest word of the year 2010. According to the jury, excluding all alternatives from the political decision-making process inappropriately prevents every kind of discourse or argumentation (SPIEGEL ONLINE, 2011).

Especially in the context of the recent *European Sovereign Debt Crisis (ESDC)* this non-word played an important role. Since 2010 German chancellor Angela Merkel repeatedly used it to declare her financial rescue packages for Greece and other highly-indebted countries as inevitable. This led to steadily rising amounts of aid money for the problem children among the eurozone countries.

As a result of Merkel's "*alternativlos*"-policy, critical parliamentarians within the fractions of the German Bundestag are significantly constrained in their freedom of speech (ZEIT ONLINE, 2011). Nevertheless, although without any alternative, there still is a huge number of namable experts who criticise the current approach of directly funding crisis-hit states. From those experts' point of view the financial aid for the highly indebted states is only a purchase of a further time-span to find comprehensive solution for the eurosystem and smooths the way into a liability union.

This bachelor thesis will investigate, whether the current rescue policy of the *European Union (EU)* and the *International Monetary Fund (IMF)* is really as "*alternativlos*" as it pretends to be. Therefore, it will pick up the frequently mentioned proposal of an orderly insolvency procedure for sovereign states and answer the main research question:

***Is, under the current circumstances, the introduction of an orderly insolvency procedure for sovereign states a more effective way to counter the ESDC than the funding of crisis-hit countries?***

As the effectivity is difficult to measure by means of quantitative scale, this study consists of a case study using qualitative analysis of secondary literature

to gain comprehensive information about the crisis, its causes and its remedies. Hence, it bases on the in-depth analysis of secondary literature. Especially before the background of the behavioural concept of moral hazard it will try to explain the origin of the crisis. A sub-question of this study thus is:

***What major factors caused the current European Sovereign Debt Crisis?***

The work will point out that especially disincentives induced by structural misfits of the EMU were likely to foster excessive debt-making and risky lending behaviour. These findings in the following play an important role for the assessment of the two remedies. This evaluation is two-dimensional and concentrates on the *short-term effectivity* to even overcome the crisis and the *long-term effectivity* to prevent future crises. Especially in the long run the findings about the origin are assumed to be important.

As an insolvency procedure for sovereign states has not been comprehensively developed or even implemented until now, this work will collect important considerations about the characteristics and requirements of such a mechanism from the literature. Respecting these considerations, I will elaborate the essentials of a restructuring mechanism for the *European Monetary Union (EMU)*. In a further step, I will analyse the expected effectivity of this alternative approach and point out the hypothetical benefit of an insolvency of the most threatened EMU Member State, Greece. Another sub-question thus is:

***Could Greece function as an adequate leading case for a state insolvency among the EMU Member States?***

After analysing both approaches, the currently implemented and the alternative separately, their effectivity will finally be compared to answer the major research question. The final review will show that the officials should rather reconsider their approach instead of following

I expect this work to be especially of practical respectively social relevance. The main research question is one that affects the leading EU

politicians as well as the common man. As outlined before, its possible answers are discussed controversially. This work will contribute significant insights about the effectiveness of the discussed remedies and give a concrete suggestion for the further handling of the crisis. Although critics might doubt the validity of the analysis due to its qualitative single unit approach, this study might at least highlight important mechanisms that serve a consistent explanation for the occurrence of the ESDC. Furthermore, it elaborates aspects that should be considered when evaluating the effectivity of each remedy. Despite its mainly practical orientation, the following will also underline the explanatory power of the moral hazard concept by applying it on the run-up of the crisis. Findings will show that this rational choice based concept is capable of logically explain causal mechanisms in advance of the ESDC.

## 1.1. Data collection and research design

As the main research question suggests, this study addresses a primarily practical problem: The question of *which remedy is capable of countering the ESDC more effectively*. To answer this question, I have to compare the effectivity of the current rescue approach with the effectivity of the introduction of an orderly insolvency procedure for states. Before finally doing this comparison and giving a suggestion for the further handling of the crisis, I at first have to analyse the causes of the crisis and assess the effectivity of both approaches. This assessment is done separately for each remedy.

Following sub-chapters will lay down the method of data collection and the general research design of this study. As it would be inadequate to fully absolve this method from possible criticism, this criticism will be considered by a critical assessment within the fourth chapter of this paper.

### 1.1.1. Qualitative analysis of secondary literature

This work primarily draws on the qualitative analysis of secondary literature. Whilst *primary research*, also known as *field research*, aims at collecting and analysing new data, this so called *desk research* makes use of already existing data (Lauth & Winkler, 2006). Due to the high topicality of the ESDC, I use electronic sources, such as online journal articles and recent publications from research institutes or official institutions, for long periods of this work. Nevertheless, during the analysis of the ESDC's origin and the current approach

I also refer directly to the *Treaty on the Functioning of the European Union (TFEU)*, a primary source. Furthermore, especially concerning the development and investigation of an insolvency mechanism for EMU Member States, I also pick up important insights from traditional scientific print sources. At this point, I would like to refer to the book *Staateninsolvenz* published by Kodek and Reinert and Birte Kemming's *Insolvenzverfahren für Staaten - Völkerrechtliche Vision? Ökonomische Notwendigkeit?*. Both already covered the topic of state insolvency intensively and contributed important background knowledge for this thesis. However, although the topic of state insolvency is nothing new to the scientific literature, the European Sovereign Debt Crisis, as a crisis within a highly integrated monetary union, is certainly a novelty. An intensive investigation of its reasons and the expected effectiveness of possible remedies hence is undoubtedly an interesting and topical subject for a bachelor thesis.

The information which is investigated in this paper is gained by qualitative analysis. In opposite to quantitative methods which try to collate measurable and quantifiable data about the quality of phenomena, qualitative analysis is mainly a hermeneutic process of interpretation (Here: of secondary literature) (ibid.; Weyers, n.d.). Within the limited range of this work, one major advantage of using secondary literature is that it is easy to access. Furthermore, because of the complexity of this work's subject, the ESDC, and the difficulty to quantify or even standardise the relevant variables, qualitative analysis of secondary literature appears as an appropriate approach. While it is hard to quantify the insurance effects of specific structures of the EMU or the effectivity of a rescue approach, they can be captured much easier through hermeneutics.

### **1.1.2. Case study: The European Sovereign Debt Crisis**

This study consists of an intensive study of a single unit, the ESDC, with focus on its causes and its remedies. Hence, the general research design used in this study fits Gerring's (2004, p. 341) definition of a case study "*as an intensive study of a single unit with an aim to generalize across a larger set of units.*" He differentiates four major types of this *small-n approach* by means of two criteria: the temporal and the spatial variation. To observe changes and draw inferences about causation, the researcher can either compare different units *temporarily and spatially* (Dynamic comparison), *only spatially* (Spatial comparison) or *only temporarily* (Longitudinal comparison). If there is no

variation in space and time to observe, the researcher can assume a hypothetical time dimension to draw theoretical inferences about causal relationships (Gerring & McDermott, 2007). This kind of a thought experiment is called *counterfactual comparison*.

At first, I will analyse the history of the ESDC to explain its occurrence and furthermore the characteristics of the current rescue mechanism. The observation starts before the actual beginning of the crisis and goes until today. According to Gerring's classification system, this over time approach is a longitudinal comparison of cases (Information gained by the different observations) of a single unit (The ESDC). A spatial variation is not given. Dealing with the alternative approach, I will go further and investigate the possible future scenario of a Greek insolvency. This can only be done by a thought experiment, as this future case is not observable in reality. Hence, this work's case study of the ESDC also includes a counterfactual comparison.

Although case studies do not allow to sufficiently prove causal effects - this can only be done by using experimental designs and control groups that enable the researcher to control for third variables (Shadish, Cook & Campbell, 2002) - they allow to "*shed light on causal mechanisms*" (Gerring, 2004, p. 349). Hence, the intensive investigation of the ESDC allows me to highlight mechanisms that might have caused the crisis. The causal mechanisms are revealed by so called *process tracing* (Gschwend & Schimmelpfennig, 2007). "*The general method of process tracing is to generate and analyze data on the causal mechanisms, or processes, events, actions, expectations, and other intervening variables, that link putative causes to observed effects.*" (Bennett & George, 1997) Important in this regard is the later explained theoretical concept of *moral hazard* which assumes *insurance effects* to foster excessive debt-making. Following this assumption, one crucial independent variable to explain the occurrence of the ESDC thus is the *existence of insurance effects*. The procedure of process tracing will bring these theoretical assumptions together with the empirical observations (Wiß, 2011). Nevertheless, also other factors that might explain the occurrence of the crisis, like for example the financial and banking crisis and country specific factors, will be recognised during the investigation.

Such a qualitative approach that wants to explain the occurrence of a certain phenomenon (Y) as comprehensively as possible by means of several independent variables ( $X_i$ ) is called *Y-centred* (Gschwend & Schimmelpfennig, 2007). Just in line with the first sub-question of this paper, Gschwend and Schimmelpfennig (2007, p. 22) state that Y-centred approaches usually ask: "*What causes Y?*" As this study also aims on explaining the occurrence of the ESCD comprehensively, the use of a Y-centred case study design that consists of the in-depth analysis of the crisis seems appropriate.

### **1.1.3. Operationalisation of effectivity**

The most important variable of this study is the remedies' *effectivity*. Effectivity is operationalised two-dimensional. On the one hand, the *short-term effectivity*, or the capability of the rescue mechanism to even overcome the crisis, is of interest for the investigation. Basis of this analysis are especially considerations about the current economic situation and a country's actual *debt repayment capacity*. On the other hand, the *long-term effectivity*, in other words the *sustainability* of a rescue mechanism, is a central aspect. A rescue mechanism can be interpreted as sustainable, if it has the potential to prevent future crisis. The analysis of the ESCD's causes will point out that especially the moral hazard problem introduced by the structural misconception of the EMU contributed its share on the way into the crisis. The sustainability assessment thus primarily investigates the incentive structures of the rescue mechanisms. I assume that a sustainable approach respects the causes of the crisis and mainly the implications from the moral hazard concept. Hence, it has to provide an incentive structure that is likely to foster financial discipline, instead of functioning as an insurance against default, for creditors, and against insolvency, for debtors.

### **1.1.4. The two remedies: Real vs. hypothetical scenario**

As aforementioned, this work, on the one hand, deals with the evaluation of a remedy which is already implemented. Its characteristics can thus also be observed in reality. To gain information about its effectivity, and more precise its incentive structure, I will highlight the most important characteristics of this real scenario and then analyse the implications of these on the over all effectivity of the approach.

On the other hand, the alternative approach bases on merely theoretical considerations. Due to the fact that an insolvency mechanism has neither been implemented nor been comprehensively developed until now, I have to elaborate the most important characteristics of such a mechanism with respect to historic approaches to face the phenomenon of state insolvency and latest scientific considerations. After pointing out the characteristics of a restructuring mechanism for the eurozone, I investigate the expected benefit of its application in the specific case of Greece. The study depends on this hypothetical scenario as it is not observable in reality, especially not in such a unique context as the ESCD's. Respecting Gerring's classification system, this thought experiment is a so called *counterfactual comparison*. A real temporal variation is not available, thus I assume a hypothetical future scenario (on basis of the prior considerations about state insolvency procedures) that includes the application of the alternative remedy. The analysis of this hypothetical scenario is the ground for the final effectivity comparison and enables me to answer the more specific sub-question of this work, whether Greece could serve as an appropriate leading case for a state insolvency among the EMU Member States. This question can be affirmed, if the expected positive impacts of the restructuring outweigh the negative consequences.

## 1.2. Theoretical considerations / Moral hazard

In context with the ESCD, its causes and its remedies, one term is frequently mentioned: *Moral hazard*. The term is endemic to the insurance business and refers to the behavioural change of insurants when getting covered against specific risks. The theoretical idea of moral hazard bases on the behavioural theory of *rational choice* according to which all individuals are assumed to act rationally. Rationality in this context means that the individual tries to maximise its utility by adopting a certain course of action that is assumed to provide the highest net gain. To assess the net gain of a certain action, the individual weighs the costs and the benefits on basis of its own preferences (Dehling & Schubert, 2011). Today, moral hazard is also a common term in economic sciences which concisely means:

The tendency of an actor to take inadequately high risks because of the fact that the damage/cost of the risks is carried by someone else.

Or in other words:

The risk that the conclusion of an insurance lowers the inducements to act carefully and aware of risks.

Consistent with these definitions, Paul Krugman states that moral hazard is a threat in "*any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly.*" (Krugman, 2009, p. 63) Krugman's citation underlines the strong link between moral hazard and the concept of rational choice. Moral hazard is caused by the possibility to maximise the own utility through burdening someone else with the costs. Moreover, this problem especially occurs when the interests of the actor who takes the risk and those of the actor who pays the costs are not aligned. According to Kemming (2007) moral hazard is caused by an asymmetry of information by which the insurer is not able to fully observe or even control the behaviour of the insurant. From an economic point of view it can be differentiated into two different kinds.

On the one hand, there is the so-called *debtor moral hazard* which focuses on the borrowing behaviour of states. If a state expects a bail-out, for example by the IMF, in case of a solvency crisis, its incentive is high to excessively finance itself on credit. Because of the fact that the risks are carried by a superordinated institution, the incentive is also high even if the state does not expect to be able to pay the credits back at all. Hence, the expected bail-out can figuratively be interpreted as an insurance against insolvency.

On the other hand *creditor moral hazard* focuses on the lending behaviour of creditors. If creditors can expect a bail-out for insolvent debtors, the risk of payment default is minimised and they have high incentive to lend money to those countries. Under normal circumstances the high default risk would result in rising interest rates for government bonds. The simple principle behind these rising interest rates is that the bonds with the highest default risk will also pay out the highest return, if everything works out well. Among experts

this principle is called *risk-return tradeoff* (Gannon, n.d.). However, when expecting a bail-out, those interest rates may become inadequately low and do not reflect the actual risk of payment default and the financial situation of a state (Herrmann, 2011). These low interest rates are, because of the low costs for contracting new debts, again an incentive for states to live on credit.

Although the literature is at strive about the real impact of moral hazard, recent studies attest that debtor and creditor moral hazard are definitely a concern and, as a large number of experts suggests, it is also one key problem that led into the crisis (Bank of England, 2003; Feld, 2012). The following parts will take up this point and investigate what structural deficits of the EMU were likely to foster a moral hazard problem. Furthermore, the assessment of the current rescue mechanisms and also of the alternative approach of state insolvency will concentrate on the likelihood to foster or prevent such problems.

## 2. The current approach

### 2.1. The origin of the euro crisis

In opposite to a widespread misunderstanding, the roots of today's crisis within the eurozone do not simply date back to the bankruptcy of Lehman Brothers and the accompanied beginning of the world financial and banking crisis in 2008. Indeed, the necessary bail-outs for credit institutes during the course of the crisis were the main reason for the problems in Ireland, a country which was considered as a neo-liberal role model until then (Leibiger, 2011). However, in total especially structural problems of the EMU in advance of the ESDC contributed its share on the way into the crisis (Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, 2012). The following remarks will show that these structural misfits fostered the *moral hazard* and which furthermore induced excessive credit financing of national budgets due to unduly cheap conditions for government bonds.

#### 2.1.1. Unreliable insolvency risk

The EMU or rather monetary unions in general constitute significant implications for the monetary policy of each member state. By joining a

monetary union, a state relinquishes from practising an autonomous monetary policy (German Council of Economic Experts, 2011). In the specific case of the EMU this means that the monetary policy for the whole eurozone is transferred to the *European Central Bank (ECB)* as an independent administrator (Potacs & Mayer, 2011). Due to the formal independence of the ECB member states are no longer able to finance their sovereign debt through printing new money (*monetisation of sovereign debt*). By implication this means that there is a possibility for states to become insolvent, or as the German Council of Economic Experts (2011, p. 92) points out: "*[B]y joining the EMU the euro area member states have fundamentally changed the framework for their government financing. The debt is denominated in euro without them being able themselves to have their respective central banks put up the means to repay the debt. By adopting the euro, the member states have thus assumed the risk that they may have to default on payments, something otherwise only incurred in this form by emerging markets that have to take up debt in foreign currency [...]. Commentators talk in this context of 'original sin'.*"

Within the legal framework of the EU this risk of a state insolvency should be underlined by the *no bail-out rule* of Art. 125 I of the *Treaty on the Functioning of the European Union* according to which the union as well as the member states "*shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State*". Furthermore, Art. 123 TFEU was meant to prohibit the ECB and the national central banks of the member states from providing credit facilities to or purchasing debt instruments from other member states (Herbert Smith, Gleiss Lutz, & Stibbe, 2010). The constructors of the EMU assumed that such provisions would ensure that the member states have to refinance themselves under market conditions which furthermore should encourage them to a solid and sustainable fiscal policy (Potacs & Mayer, 2011). However, although these provisions superficially emphasised the risk of a state insolvency for the member states of the EMU, the history has proved that neither the indebted states themselves nor the investors on the financial markets believed in it (Fuest, Franz, Hellwig, & Sinn, 2010). Table 1 and Figure 1 show that in the years before the crisis today's problem countries, for example Greece and Portugal, were able to refinance themselves

under likewise cheap conditions as solidly budgeting states like France or Germany did, although the default risk of such countries' government bonds was obviously higher (Initiative Neue Soziale Marktwirtschaft, 2010). The fact that the interest rates for government bonds were unduly all at one level indicates that the possibility of credit default was simply faded out. As a result, the annual budget deficit, especially in Greece, lay clearly above the long-term limits of three per cent of the GDP as set out in the treaties (More information regarding these limits in the sub-chapter after next). Only when the default risk became oppressive because of the subsequent adjustment of the Greek national deficit in 2009 and the necessary bail-outs for credit institutes of the other crisis-hit countries, the markets lost their trust in government bonds as the "secure core" (German Council of Economic Experts, 2011, p. 77) of the financial system (SPIEGEL ONLINE, 2010b). Consequently, *rating agencies* lowered the rating of those countries' creditworthiness, *risk premiums* on their bonds surged and the refinancing at the financial markets became nearly impossible for the crisis-hit states (Leibiger, 2011). This was the beginning of a vicious cycle: higher interest rates caused higher sovereign debt and this again led to higher default risks and rising interest rates (Weder di Mauro, Schmidt, Feld, Bofinger, & Franz, 2012). Coincidentally the interest rates e.g. for German government bonds, which were now seen as the *safe haven*, even became negative until today (Donovan, 2012; Wörmann, 2012).

An important question now is, what led creditors as well as debtors into fading out the risks of a state insolvency. As Potacs and Mayer (2011) attest, the legal framework of the EU treaties aimed only at preventing the case of an insolvency. Indeed, the aforementioned provisions underlined the possibility of a state insolvency, but they did not provide any procedure of what to do when the case of an insolvency really occurs. Measures like the *Stability and Growth Pact (SGP)* and its *Maastricht Criteria* only intended to prevent excessive state deficits. Thus, one explanation for the underestimated default risks would be that the lack of a specific insolvency procedure induced creditors as well as debtors to expect that insolvency is simply not designated to happen (ibid.). In addition to this, it was obvious for all market actors that the *equity capital* of the private creditors would not prevent a large number of so-called *system-relevant banks* from going bankrupt as well (Hau & Lucke, 2011). Bearing in mind the

large effects of the bankruptcy of Lehman Brothers on the world financial system, these systemic institutes developed an enormous *blackmail potential* towards the governments of the eurozone. Feld (2012) considers that even an actual insolvency procedure, written down in the treaties, would not have eliminated this kind of *creditor moral hazard* constituted by these *too big to fail creditors*.

### **2.1.2. Insufficient enforcement of the Stability and Growth Pact**

Next to the moral hazard problem fostered by the unreliable insolvency risk, the aforementioned regulations to prevent an insolvency by encouraging budgetary discipline turned out to be toothless tigers.

Formally, the SGP is a mechanism of mutual supervision and intends to monitor whether the member states comply with the Maastricht criteria which allow a maximum annual budget deficit of three per cent of the GDP and a maximum national debt of 60 per cent of the GDP (Potacs & Mayer, 2011). The compliance with these criteria is seen as a general requirement of future stability of the EMU (European Commission, 2012b). The SGP consists of several political texts and secondary law acts but its general legal bases are Art. 121 and 126 TFEU in conjunction with the additional protocol no. 12. Art. 126 I TFEU for example constitutes that "*Member States shall avoid excessive government deficits.*" If a member state does not comply with this rule which is furthermore specified by the Maastricht criteria, the European Commission may initiate a so-called *excessive deficit procedure*. This procedure formally provides different sanctions against the debtor country right up to substantial monetary penalties. Nevertheless, if a penalty is really called or not is, at long last, decided by dual qualitative majority of the Council of Ministers (EUROPA, 2011). In other words, in the end the representatives of likewise indebted countries have to decide about sanctions against other debtors (Heithecker, 2010). This arrangement provides an atmosphere of latent fear. Concisely said, if *country one* votes for sanctions against *country two*, it has to fear that *country two* will do it conversely, too. Hence, the incentive not to vote for sanctions is high for those countries which have to expect that in the future an *excessive deficit procedure* will also be initiated against themselves. This area of tension peaked when in 2003 Germany and France, both higher indebted than allowed by the SGP (See: Figure 3), in mutual consideration asserted the suspension of *excessive deficit*

*procedures* against them. Then in 2005, these two countries made a high contribution towards the formal watering of the pact which extended the leeway to make debts significantly (Initiative Neue Soziale Marktwirtschaft, 2010). As Herrmann (2011) points out, the European Commission until autumn 2010 recognised 68 offenses against the SGP which were followed by the initiation of an excessive deficit procedure. None of those those procedures resulted in sanctions. The missing sanctions for member states apparently declared excessive contracting of debts as legitimate. This misappropriation stands for the extreme opposite of the SGP's original aspiration of ensuring future stability for the EMU. The design of the SGP made the member states expect that there will be no sanctions in case of offending the limits set up in the treaties. Obviously, this rather increased the incentives for member states to live on credit instead of lowering them. Figure 3 shows that the debt level of today's crisis-hit states Greece, Italy and Portugal continuously lay above the 60%-limit of the GDP without any tendency of consolidation. However, the graph also underlines the aforementioned fact that especially the Irish crisis was caused by the world financial and banking crisis in 2008, until then the country had a debt level clearly beneath the legal limits.

It became clear that the constitutional arrangements were likely to foster a *moral hazard problem* on side of the debtors as well as on side of the creditors. Missing sanctions for debt sinners and the lack of a clear procedure for insolvent states subtextually functioned as an insurance against the actual high default risk and even an insolvency at all. All this fostered further debt-making and can obviously be seen as important factors that caused the crisis.

### **2.1.3. Other factors**

Additional to the aforementioned causes also the immense economic imbalances between the members of the eurozone and missing efforts on competitiveness of today's problem countries took their toll.

As Figure 2 indicates, there were significant differences concerning the economic power of the eurozone member states since the beginning of the EMU. Whilst countries like Germany, Austria and the Netherlands constantly obtained significant surpluses in their balance of trade, many other member states, amongst others also the crisis-hit countries of today, constantly registered trade deficits (Initiative Neue Soziale Marktwirtschaft, 2010).

Furthermore, the aforementioned low interest rates for the EMU member states also promised cheap money for the private sector. This led into a construction and capital spending boom primarily in southern countries of the EMU. Due to missing regulations on debt making, an economic bubble developed in some of these boom countries whose burst threatened the stability and functioning of the bank system and highly stressed the national budgets (Fuest et al., 2010). This burst can be seen as *initial ignition* for today's ESDC but overall not as the only and most important cause.

The Ifo Institute (2011) states that the debt financed economic boom led to an increase of wages and prices clearly above the long-term equilibrium. This process had important implications for such countries' competitiveness: exportations became more expensive while importations became even cheaper. Because of the high costs such countries were not able any longer to sell their products to the foreign world. Hence, after the burst of the bubble those countries are now facing not only the threat of their high budget deficit but also the structural problem of uncompetitiveness. The impossibility of a devaluation of the Euro by the national banks unveils that the only way to regain competitiveness for these countries are structural reforms and for example wage and price reductions (Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, 2012). Such structural reforms are an important condition for a country's drawdown of the EU's financial rescue packages (European Commission, 2012b). Especially in case of Greece this so-called *austerity mandate* evoked strong resistance from side of the Greek population. Apart from the merely economic point of view this strong and enduring resistance shows that these necessary reforms have also an important social dimension. Wage cuts and job losses, because of the restructuring of the public sector, let the people directly feel the consequences of the crisis in their private life (Leibiger, 2011).

The specific case of Greece also unveils that all these problems were also accompanied by a high level of corruption, nepotism and inefficient public administration that highly strained the national budget and fostered the countries uncompetitiveness of today (Landeszentrale für politische Bildung Baden-Württemberg, 2012).

## 2.2. Critical view on the current rescue strategy

Before discussing the current approach of rescuing the crisis-hit countries among the EMU member states, one has to be aware of the stress field in which all measures move.

On the one hand a major intention of every rescue mechanism should be to ensure the financial market's believe in the future solvency of the crisis-hit countries. This regained trust might break the aforementioned *vicious cycle* by lowering the interest rates on bonds of such countries and enabling them to again refinance themselves under market conditions as proposed in the treaties.

On the other hand the constructors of the rescue mechanisms have to draw their lessons from the aforementioned structural deficits of the EMU and especially consider the specific implications concerning the problem of moral hazard. Here, an important consideration has to be that the current crisis cannot be solved and especially future crises cannot be prevented by simply assuming liabilities through the union. The prior sub-chapters should have clarified that such an approach is doomed to fail because of creating incentives for further debt-making and risky lending. Briefly, the perfect remedy has to find an adequate tradeoff between the creation of a liability union and the complete restriction of mutual financial aid. Due to this difficult starting situation it is obvious that an convincing model for resolution has to be constituted of a package of different measures.

Nevertheless, the following will concentrate on the current strategy's main principle of financial support for the crisis-hit states to prevent a de facto insolvency. Further measurements to ensure a sustainable and stable EMU and to counteract the aforementioned misfits are undoubtedly necessary, but will only be discussed marginally.

### 2.2.1. Ensuring the solvency of EMU Member States

Since the most obvious starting point of the crisis, Greece's subsequent adjustment of its national deficit in winter 2009, until today a large bunch of different measures was adopted. By ensuring the solvency of the financially tottering states all these measures aim at "*preserving the financial stability of the EU.*" (European Commission, 2011) Before assessing the approach, the general details of these rescue packages will be briefly described.

The story of the so-called euro rescue packages began with 110 billion euro of bilateral credits (80 billion from eurozone countries and 30 billion from the IMF) for Greece, after the country's creditworthiness rating was significantly downgraded by the big rating agencies in the end of 2009 (Lang, 2012). In May 2010 the ministers of finance of the eurozone countries extended their efforts on ensuring the refinancing of all crisis-hit countries. Affected from the burst of the housing bubble also Spain lost its top rating and had, as well as its highly indebted neighbour Portugal, to adopt a strict austerity program. The former *celtic tiger*, Ireland, had to declare the drawdown of the new rescue packages in November 2010 (ibid.). While the aforementioned emergency funding for Greece was the result of an ad-hoc action, the ministers now tried to establish a clear scheme for the handling of further (nearly) insolvency cases that can be applied on every member state of the eurozone. The so-called *European Financial Stabilisation Mechanism (EFSM)* derives its funds from the budget of the EU itself and has a financial volume of 60 billion euro. Furthermore, the *European Financial Stability Facility (EFSF)* provides an amount of 440 billion euro through guarantees of all eurozone member states. Together with the additional 250 billion euro from the IMF, the total amount of this new "*safety-net*" (European Commission, 2011) adds up to 750 billion euro (Raifeisen RESEARCH, 2011). Until today, an amount of approximately 277 billion euro has been disbursed (From all rescue packages) to Greece (June 2012: 183 billion), Ireland (March 2012: 46,45 billion) and Portugal (May 2012: 48,3 billion). However, the whole amount of the rescue programs for those states, including the pending disbursements, is significantly higher (European Commission, 2012a; European Financial Stability Facility, 2012). Moreover, recent developments at the beginning of June 2012 unveiled that also Spain has demand for financial aid. Hence, further drawdowns of the rescue packages in the near future can be seen as inevitable.

This direct lending has often been criticised to be undermining the aforementioned no bail-out rule of Art. 125 TFEU. The EU officially justifies these loans for crisis-hit countries through Art. 122 II TFEU according to which "*the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to a [the] Member State*" but only if the "*Member State is in difficulties or is seriously threatened with severe difficulties*

*caused by natural disasters or exceptional occurrences beyond its control*". The officials argue that the impossibility of a refinancing over the market is a situation beyond the control of the affected states. Indeed, these Member States are not able to reassure the markets by themselves. However, this argumentation disregards the fact that the current situation, in most of the crisis-hit countries, is the result of a period of insufficient budgetary discipline which was definitely under their control (Potacs & Mayer, 2011). Furthermore, the main idea of the no bail-out rule was to admonish the Member States to stabilise their budgets. When in the end a situation caused by unsound finances and ignorance of the budgetary implications from the treaties is interpreted as *beyond the control of a Member State*, the thought that the no bail-out rule is as insufficient as everyone expected it to be immediately suggests itself (Fuest et al., 2010).

A further argumentation of the officials is that the Union does only lend money which will be repaid in the future. By this they try to distance their approach from *assuming liabilities* as mentioned in the no bail-out rule (Potacs & Mayer, 2011). However, this argumentation clearly disregards the likelihood of the repayment of their lent money. Figure 3 shows the debt level of the crisis-hit countries. Literature assumes that from a specific level the repayment of debts becomes impossible for a state (Waibel, 2011). Although the experts are discordant about the concrete limitation point of a state's debt repayment capability, the debt level especially in Greece is very likely to have passed this point (Heinrich, 2012). Hence, from an objective point of view, the saviours have to expect a default on these lendings (Potacs & Mayer, 2011). By providing credits with interest rates significantly lower than the market's the rescue packages ignore this risk. This can be interpreted as the deliberate assumption of liabilities. Furthermore, the argument of the limited debt repayment capability leads to the general question whether the direct funding of the crisis-hit countries' sovereign debts as a solution is even capable of solving the crisis. The fact that the rescue packages did not evoke a significant sedation on the financial markets and by this lower interest rates on government bonds clearly emphasises this scepticism. This inference is reasonable, because, as Wittmann (2010) points out, although nobody exactly knows the objective limit of a state's repayment capability, at least the markets will recognise it by increasing the

risk premiums. Despite the intensive efforts of the EMU Member States, those risk premiums remain high.

Although the states have to initiate strict austerity programmes as a condition for participating in the rescue packages this approach obviously evokes a moral hazard problem. It contains the transfer of credit risks from private creditors to public ones (Fuest et al., 2010). Hence, the rescue packages function as a kind of insurance for the private creditors against default risks. Especially as future prospect this seems highly problematic, because, as shown above, the expected bail-out was an important cause for the excessive risky lending in advance of the crisis. The current approach and also the future permanent *European Stability Mechanism (ESM)* which shall succeed the temporary EFSF are thus likely to maintain the problems that caused the crisis instead of abandoning them. Despite the repeated justification through Art. 122 II TFEU by the officials, at least the negative connotation and a mistrust in the given treaty regulations remains.

The same holds true for purchase of government bonds of the tottering states through the ECB. Since May 2010 the *independent* administrator bought bonds with a denomination of more than 200 billion euros of all crisis-hit states (WELT ONLINE, 2011). This led to intensive objections from side of acknowledged experts who criticised this action to threaten the stability of the whole eurozone (SPIEGEL ONLINE, 2010). As a result of this policy, the member of the ECB Governing Council and designated head of the ECB, Axel Weber, receded from his office (Leibiger, 2011). In addition to the possible threats concerning price stability, this way of financing the crisis-hit states could also be interpreted as a breach of Art. 123 TFEU which forbids the direct central bank financing. Officials justify this approach by the fact that the ECB only acts on the secondary market. Instead of purchasing the bonds directly from the Member States, the ECB purchases them from private actors (Brockmann & Keppler, 2012). Nevertheless, the result remains the same, the *monetisation of sovereign debt* which is seen as *a central bank's capital sin* by a huge fraction of economic experts (Franz, 2011). The intention of Art. 123 TFEU is to prevent such practises and to preserve the independence of the ECB. Thus, it is understandable that major critics see this action as another case of unreliable treaty provisions.

Bearing in mind the causes of the crisis, the current approach does not convince. As shown before, mistrust in treaty provisions was one major point that led into the crisis. Critically investigated, the current packages can at worst be interpreted as the manifestation of the erosion of treaty provisions and as the foundation of a liability union (Herrmann, 2011). At best, they even leave a certain mistrust in future commitment to budgetary discipline. As long as the EU does not succeed to regain the trust in their own legal framework from all actors on the financial markets, also further measures like the *European Fiscal Compact (EFC)* will come to nothing. The past, too often, has proved the unreliability of such commitments and the fact that the officials still refuse to introduce an automatic deficit procedure emphasises this problem even more.

### 3. State insolvency as an alternative

*"When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor."* (Smith, 1776, p. 930)

Originating from Adam Smith's fundamental work *"An Inquiry into the Nature and Causes of the Wealth of Nations"*, first published in 1776, this quotation illustrates that the idea of an orderly insolvency procedure is no kind of reinvention or even first initialised by the current crisis. Rather, the topic has a centuries-long history which will also be thematised in this chapter.

With the beginning of the ESDC and especially in context of repeated Job's messages concerning the political and economic situations of the problem countries, with Greece leading the way, a debate about this long time unsaid possibility of state insolvency fired up. Raffer (2011, p. 33) describes an orderly procedure for insolvent states as a *"commandment of economic rationale"* (Own translation) and even the Managing Director of the International Monetary Fund, Christine Lagarde, pleaded in favour of a refinanciation for *system relevant banks*, in case of solvency problems caused by bankrupt states (Lagarde, 2011). This chapter will point out the general feasibility and aims of an orderly insolvency procedure for states and give a review on historic

examples. Then, after investigating how an insolvency procedure for the EMU could look like, it will concentrate on today's specific example of Greece and ask whether this could be a leading case for a state insolvency among the members of the eurozone.

### 3.1. Feasibility of state insolvency

An insolvency procedure in civil law is a foreclosure against privates (Feldforth, 2011). It is regulated through national legislation and generally aiming at the closing down of the pecuniary relations between a debtor and a creditor by administration of a third party (Kemming, 2007). A frequently mentioned problem concerning insolvency procedures for sovereign states is that the world of states has neither a superordinated legislation nor institutions that are meant to conduct such procedures. Hence, a common dogma in international law is the *incapability of states to become insolvent* (Reinisch, 2011).

Supporters of this line of thought stress that a foreclosure against nation states would be an intensive intervention in the sovereignty of those states. They underline that state sovereignty is a commonly accepted principle of the international relations and an essential element of every nation state (Baylis, Smith, & Owens, 2008). Some even equal this principle with *statehood* itself (Szodruch, 2008). According to this argumentation states, as the highest instances in international law, simply cannot be subject to a procedure which directly constrains their sovereignty (Aden, 2010).

Furthermore, resulting from the sovereignty of every state, skeptics also question the general economic possibility for those to become insolvent. They point out that a state always has the possibility to find legal arrangements, such as for example higher taxes or less social benefits, that may guarantee its solvency. Hence, according to them, a state can only go through temporary periods of illiquidity but not become insolvent at all (Szodruch, 2008). However, history has proven the practical invalidity of this dogma. The historic examples thematised in the sub-chapter after next and especially the case of Greece during the current crisis show that the insolvency of a state can easily become reality. Moreover, the assumption of a state's unlimited financial resources disregards the fact that the borrowing costs also influence a state's growth and its income. It is apparent that these are factors that determine how much a state

can actually take from its people (Kemming, 2007). In addition to this economic perspective, also the sociopolitical implications may not be ignored. A sovereign state is responsible for the stability within its borders and by this also for the welfare of its citizens. Too intensive incisions in the social systems may threaten these aspects, in the long run. Hence, there is also a sociopolitical limitation to this kind of a state's funding capacity (Marauhn, 2003).

Overall, the argument of sovereignty is not capable of refusing such an insolvency procedure for states steadfastly. Especially in respect of a phenomenon like *globalisation* and its accompaniments of *global trade* and appearance of private *global players*, the adherence to this image of a world system seems inappropriate and outdated (Kemming, 2007; Baylis, Smith, & Owens, 2008). Nevertheless, the advisory board at the German Federal Ministry of Economics and Technology points out that the sovereignty of a state definitely implies certain requirements that set an insolvency procedure for states apart from those for private individuals. However, as long as these requirements are guaranteed, a general collision with the principle of sovereignty cannot be stated (Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, 2012). In this regard three major points are to be considered:

- *Voluntariness*: One cannot criticise that sovereignty is constrained, as long as the state itself decided to initiate such a procedure on bases of international treaties.
- *Guarantee of existence*: An insolvency procedure may not threaten the general existence of a state and the exertion of its vital functions.
- *Autonomous administration*: Democratic principles do not allow the takeover of the public administration and especially the budgetary policy by a third actor.

As the following sub-chapters will show, these characteristics impact the objective of a state insolvency procedure as well as the actual procedure itself.

## 3.2. Aims of an insolvency procedure

As Kemming (2007) points out, an orderly insolvency procedure, for private individuals as well as for states, generally respects two existential legal claims. On the one hand, the right of the creditor to expect repayment of debts and payment of interest. On the other hand, the contractual principle that a fulfilment of a contract may not be enforced if this would existentially threaten the other contracting party. By coordinating the actions of both parties, it guarantees the claims of a creditor to get his money back, but only as long as the debtor is not significantly threatened in his existence. In civil law this tradeoff is expressed by the *minimum subsistence level* of a private individual and for states it stands for their *vital functions* (Waibel, 2011). The term "insolvency procedure" is thus a little irritating. In distinction from a classical insolvency procedure for private companies, on state level the major intention is not to achieve a preferably high repayment ratio. Rather, a state insolvency procedure seeks to put the debt back on a sustainable level (Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, 2012). This characteristic has important implications for the procedure on state level. As in civil law there are two different ways of satisfying the claims of creditors, either the divestiture of a company and the liquidation of all its assets or the maintenance of the company, the first way cannot be an option on state level. According to Szodruch (2008, p. 21), states form a "*juridically constituted and on a lasting basis established community of people with responsibility for an orderly communal life.*" (Own translation) It is obvious that such a sovereign entity cannot be divested and liquidated. An insolvency procedure for states is thus more similar to the insolvency of a private individual, whose minimum subsistence level limits the claims of its creditors, than to the insolvency of a company. To put it in a nutshell, the *ex-post aim* of an orderly insolvency procedure for states is to efficiently reallocate the remaining non-vital assets of a debtor state and also to reach best possible conditions for a prospective sustainable and competitive economy. Paulus calls this process of a state returning to a sustainable level of debt a "*turnaround*" (Paulus, 2011, p. 14). Emphasising the negative connotations of the term *insolvency* in civil law that are largely influenced by the prevalent practice of liquidation, the most obvious and important distinction between private- and state-level is that an insolvency

procedure for states can only be seen as a rescue mechanism (ibid.). Nevertheless, as Raffer (2011) points out, also creditors benefit from an insolvency procedure since it minimises the damage and problems for all involved parties.

Additionally, the literature commonly agrees that an orderly insolvency procedure can also function as an incentive for more budgetary discipline (Herrmann, 2011). In other words, the *ex-ante aim* of an insolvency procedure is to prevent states even to become insolvent (Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, 2012). Important requirement for this preventive function to work out, is the existence of a sanction mechanism that becomes effective in case of insolvency (Kemming, 2007). The *ex-ante aim* concerns the debtors as well as its creditors. A reliable sanction mechanism shall induce the states to adopt measurements for more fiscal discipline, avoid excessive deficits and prevent them from deliberately pretending to be insolvent, with the intention to obtain debt reductions. On side of the creditors an insolvency mechanism shall counteract risky lending and foster the market-conform assessment of a state's solvency. The previous chapter has outlined the dangerous effects of an expected bail-out through a third party on financial discipline and lending behaviour. Thus, the reliability of the procedure and the threat of payment default may not be raised to question and impair these positive impacts of an orderly insolvency procedure. Focusing on the disciplinary *ex-ante aim*, it becomes clear that an orderly insolvency procedure is most efficient as long as it is not enforced at all (Paulus, 2011).

### 3.3. Historic review

Despite the fact that critics even deny the possibility of states to become insolvent at all, the history of practical insolvency cases goes back before Christ (Waibel, 2011). Indeed, the payment stoppages of ancient Greek city states does not have much in common with today's solvency crises of modern states. But, they definitely underline that the general topic of payment defaults of sovereign entities is nothing new and at least since the beginning of the modern era, *de facto* insolvencies of states were a constantly recurring event (Paulus, 2011). Waibel (2011) even deems such cases to be omnipresent in the history of the world of states. Nevertheless, until today the course of history did not yield any

comprehensive orderly procedure for the restructuring of insolvent states, neither in a global framework nor in the framework of a highly integrated state community like the EU. Rather, state insolvencies were always seen as special cases of external shock and emergency which had to be approached by individual ad-hoc measures (Reinisch, 2011). However, the current crisis features clear similarities to earlier ones. Laying down the whole story of state insolvencies between the beginning of the modern age (or even earlier) and today would be an inappropriately long undertaking within the scope of this work. Hence, the following will only refer to some succinct examples and the former approaches to a solution.

### **3.3.1. Cases of state insolvency and their causes**

The reasons for payment defaults of public debtors are manifold, but in history it was often connected to financial crises, economic cross-linkages between states, shocks of the real economy and acts of war or other political shocks (Waibel, 2011). France as an example, a serial bankrupt by the way, declared itself insolvent during the revolution in 1789 and the newly empowered Soviets in 1917 refused to account for the debts of the czar family after the October Revolution. The latter resulted in decades-long struggle concerning the repayment which was first solved in the 1990s (ibid.). With intention to avoid such long time for the restructuring of a state's finances, in the 19th and early 20th century even military interventions were a valid method to enforce the repayment of debts. In the aftermath of Mexico's insolvency in 1914 the USA for example occupied the city of Veracruz and confiscated the custom revenue (Raffer, 2011). Whilst the first two examples of France and the Soviet Union stand for a *politically induced bankruptcy*, there are also countless cases of *economically induced bankruptcies*. Even crisis-hit countries of today, namely Greece, Portugal and Spain, and the (self-declared) guardian of financial stability, Germany, were not able to repay their debts at least one time within the period between 1824 and today (Herrmann, 2011).

Especially, the strong *globalisation of capital flows* and the resulting *world-wide economic interrelations* that developed within the last two centuries contributed its share to the repetitive occurrence of financial crises in the last two centuries (Szodruch, 2008). The Great Depression of 1929, when all European states except Finland had to stop the repayment of their war credits

to the United States, unambiguously unveiled the crisis potential of globalised financial markets (Waibel, 2011). Furthermore, in line with the abovementioned reasons for state insolvencies, the two world wars caused payment defaults on sides of all involved states. After a relatively calm period of slight private lending, from the 1970s on state insolvency became a phenomenon characteristic for emerging market economies and affected the industry countries rather limitedly (ibid.). Here, primarily the aforementioned *original sin* or in other words the accumulation of debts denominated in a foreign currency played a major role. Despite the limited impact of the insolvencies of emerging market economies on the big industry countries, the financial crises in Asia, Russia and Brazil in the 1990s and Argentina's insolvency of epic proportions in 2001/02 induced a debate on a new international financial architecture (Kemming, 2007). Szodruch (2008) emphasises that primarily the crisis in Asia in 1997 again unveiled the destructive power of the international financial system. The half a century ago undreamt-of possibilities concerning the exchange of capital, goods, information and ideas, or in other words *the globalisation of the world economy*, led also to a *globalisation of crises*. The world financial and banking crisis triggered by the collapse of the US bank Lehman Brothers again reinforced this impression that participants of the highly interrelated network of the international financial sector are also highly threatened by *contagion* (Gai & Kapadia, 2010). Through such effects the, at first glance only local, crisis of the U.S. bank Lehman Brothers could infect its trade partners all over the world and by this significantly threaten the whole financial system.

### **3.3.2. Missing orderly procedures**

Although insolvency procedures cannot be assumed away from national level for hundreds of years, the globalisation of the world economy was not attended by the establishment of structures which regulate the case of payment default of a sovereign contracting party within the international system (Kemming, 2007). The only insolvency law for sovereign entities can be found in the USA. Chapter 9 of its *bankruptcy code* regulates the insolvency procedure for *municipalities* which are defined as *government units or instrumentalities of a state* (Kodek, 2011). An orderly procedure on state level is not existent and, to this date, restructuring and debt relief attempts for states mainly stood out due to their

ad-hoc character. In the past, especially two bodies were in the focus of interest. The *Club of Paris* tried to compromise the bilateral claims on state level with the actual payment capacities of the debtors, whilst the claims of private banks against states were the topic in the *Club of London* (Kemming, 2007). Next to this relatively entrenched venues within the two clubs, one could also recognise occasional efforts of creditors to sue for debts in national courts or before the *International Centre for Settlement of Investment Disputes (ICSID)*. Latter is an international arbitral court which belongs to the World Bank Group (Reinisch, 2011). Moreover, the Bretton Woods-Institutions repeatedly initiated restructuring programmes to relieve the least developed countries from their debt burden (Paulus, 2011). Especially concerning the poorest of the poor, a large number of non-governmental organisations pressed for an orderly insolvency procedure for quite some time.

However, the only comprehensive and ambitious attempt to find a solution from official side came from the IMF. During the course of Argentina's insolvency in 2001 its then First Deputy Managing Director, Anne Krueger, presented the proposal to establish an orderly insolvency procedure for states (Kemming, 2007). The so-called *Sovereign Debt Restructuring Mechanism (SDRM)* based on the idea of the aforementioned US insolvency law for municipalities, Chapter 9. In its proposal the IMF provided an orderly procedure by which a state, unable to service its debts, should be enabled to free itself from the debt burden and again reach a debt level, adequate for the sustainable maintenance of its economy (Krueger, 2002). To comply with the principle of sovereignty, the SDRM was proposed to only be initiated by the indebted state itself, through stopping the debt service. Besides the relief for the debtor state, the SDRM should also protect the creditors by providing a procedure that induces the debtor to avoid further delay of the introduction of reforms. To ensure an effective and orderly restructuring of a state's sovereign debt, the proposal had planned one significant characteristic for the decision-finding of the creditors. The restructuring of a state's debt should be decided by the creditors through a majority vote that contains 75 per cent of all claims. The respective minority should have to submit to the will of this vote (Reinisch, 2011). Furthermore, the SDRM should have involved a *temporary debt deferral*, to prevent distribution battles among the creditors, *creditor protection* to

ensure that all claims are respected the same, a *special creditor status* for those lenders that borrowed money to a state, after the SDRM was already initiated, and a *neutral administrative body*, the *Sovereign Debt Dispute Forum*, to supervise the negotiations (Herrmann, 2011).

Despite Anne Krueger's attest that the "lack of adequate incentives to ensure the timely and orderly restructuring of unsustainable sovereign debts has remained an important weakness" (2002, Preface) of the financial architecture and her addressing of the "*need for a new approach to sovereign debt restructuring*" (ibid.), the IMF proposal in 2003 failed due to the resistance of the USA, Great Britain and a large part of the private sector.

In consequence, now facing a further intensive debt crises, the EMU tries to rescue itself and the indebted states through continuous ad-hoc measures and bail-outs, as pointed out in the last chapter. The following sub-chapter will, with respect to the IMF proposal, collate significant aspects for a *European Restructuring Mechanism (ERM)*.

## 3.4. A European Restructuring Mechanism

### 3.4.1. Main characteristics

In November 2010, the Eurogroup published a statement in which it sketched the characteristics of a possible insolvency procedure for the eurozone (Eurogroup, 2010). According to this declaration, starting from 2013 *Collective Action Clauses (CACs)*, contained in all new eurozone government bonds, are intended to ensure the liability of creditors in case of payment default. These clauses shall "*enable the creditors to pass a qualified majority decision agreeing a legally binding change to the terms of payment (standstill, extension of the maturity, interest-rate cut and/or haircut) in the event that the debtor is unable to pay.*" (ibid., p. 21) Complying not only with European but also with US and British law, this can be seen as the first important step to realise an orderly insolvency procedure by avoiding single creditors to inhibit the restructuring efforts of the majority (Herrmann, 2011).

Largely in line with the IMF proposal, the advisory board at the German Federal Ministry of Economics and Technology (2012) pointed out that at least four important characteristics must be bindingly regulated to create a comprehensive insolvency procedure for the eurozone:

1. *The formalities of initiation* have to be clearly written down. Previous considerations have shown that state sovereignty can only be protected when the one and only initiator of such a procedure is the debtor state itself (Raffer, 2011). Furthermore, indicators (e.g. a specific *interest burden to GDP ratio*) have to be found which allow the detection of an insolvency.
2. A *debt deferral* has to be activated starting with the state's declaration of insolvency. This means the stoppage of all interest and extinction payments (Herrmann, 2011). It shall assure the creditors that nobody accesses the remaining assets and prevent them from enforcing their claims before court. Hence, this *standstill* is one major key point for an undisturbed and effective restructuring procedure. However, because of its negative impact on the economy of an insolvent states, the application of this moratorium should rather be subject to ad-hoc decisions for each case (Kemming, 2007). Loans that guarantee the vital function of a state shall also be serviced after the initiation of the ERM. Thereby, highly indebted states are induced to start necessary restructurings before the de facto insolvency case actually occurred. This would be the least painful solution for both, debtors and creditors (ibid.).
3. A *neutral administration body*, by analogy to the Sovereign Debt Dispute Forum, has to coordinate the negotiations between the debtor state and its creditors. The *advisory board* in this regard suggests a nonpolitical institution, to avoid the politicisation of the negotiations. Hence, it proposes a special department of the European Commission or even a private law office to be assigned for this task. Moreover, the Commission itself suggests a cooperation between the European Commission, the ECB and the IMF (Herrmann, 2011). Paulus (2011) even emphasises the establishment of a specific entity, a *Sovereign Debt Tribunal*,

consisting of neutral lawyers. Nevertheless, independent from its certain constellation, this administration body shall mainly stand out for its expertise in such negotiations.

4. *A rule to prevent creditors to aggravate or even block the restructuring negotiations* has to be set up. As aforementioned, CACs could be integrated into newly issued government bonds. Indeed, this would definitely facilitate the restructuring process, but, as Kemming (2007) underlines, it is also problematic concerning debtor moral hazard. A too painless restructuring process could at worst function as an incentive for a state not to repay its debts. Although, bonds with CACs in general realise higher interest payments, the possible moral hazard problem emphasises the importance of sanction mechanisms to create incentives for budgetary discipline. As said before, the solution of the crises does not consist of one instrument. Hence, in the framework of the EU especially a strengthening of the SGP, with automatic and even harder sanctions in case of excessive deficits, could be considered as a possible countermeasure against this kind moral hazard.

In addition to these four, the aspect of *creditor protection*, as proposed in the SDRM, seems also be important for an ERM. Berensmann and Schröder (2006) actually understand this principle as the most important aspect of an insolvency mechanism. Missing debtor protection would open the floodgates for single creditors trying to enforce a repayment by themselves. Litigations and distribution battles of these creditors may even more decrease the remaining assets and stand strictly in conflict with the original intention of an orderly insolvency procedure, namely the efficient reallocation of the remaining non-vital assets of a debtor state. Furthermore, to ensure refinancing during the restructuring process, the aforementioned *special creditor-status* has to be considered. By this, new creditors can be excluded from the restructuring. This would foster the lending, although the countries creditworthiness is currently raised to question. If established, a mechanism respecting these major aspects

will represent a solid basis for restructuring negotiations and a possible way for highly indebted and crisis-hit countries to escape from their debt burden (Waibel, 2011).

Experts see the introduction of an ERM also as a constitutional revolution. Especially within a community like the EU that understands the *rule of law* as one of its major principles, introducing such a predictable and regulated procedure for the restructuring of sovereign debt has to be interpreted as a *constitutional imperative* (Raffer, 2011). The abovementioned insights from official side and the current discourse about state insolvency, hence, are definitely welcome. Nevertheless, as the following example case of Greece will show, there still are some possible threats that have to be considered.

### **3.4.2. Greece as a leading case**

Until now this chapter has pointed out the aims and characteristics of insolvency procedures for states and focused these on the EU by pointing out major aspects for an ERM. The question now is whether an insolvency could help the most tottering eurozone Member State, Greece, to overcome its crisis without threatening the stability of the whole EMU.

Many experts draw parallels between the Greek crisis of today and Argentina's insolvency in 2001/02 (Reinisch, 2011). Especially concerning the societal problems of corruption, nepotism, fiscal evasion and black economy both countries seem alike. But also the economic frameworks and the forefield of the countries' crises are similar. Whilst Argentina tied its Peso through the *Currency-Board* to the Dollar, Greece is embedded in the EMU and can thus not drive its own monetary policy (Grüttner, 2012). As a result, both countries were not able to devalue their currencies to reduce their debt burden and become competitive again. Furthermore, Argentina faced a relatively high and steadily rising debt level. In 2001 its *debt to GDP ratio* was at approximately 63 per cent (The Economist, 2012; Raffer, 2011). However, Greece is nowadays confronted with a much higher debt burden. As Figure 3 indicates, its *debt to GDP ratio* developed from 97,4 per cent in 2003, over 113,0 per cent at the beginning of the crisis in 2008, up to 165,3 per cent in 2011. Due to years of living beyond its means, Argentina in July of 2001 had to declare that it did not get fresh money from the financial markets anymore and was forced to initiate a hard

consolidation path (Mayrbäurl, 2012). Today, Greece's debts are effectively financed by the rescue efforts of the EU and the IMF. Hence, one can state that it is cut off from the financial markets, too (Sinn & Carstensen, 2010).

The several similarities between the structures of Argentina's insolvency ten years ago and Greece today, but especially the very high debt level of the latter, raise the question whether the South European country is even able to find its way out of the crisis without significantly restructuring its debts (van Suntum & Ilgmann, 2012). As aforementioned, Waibel (2011) states the debt repayment capacity of a state objectively limited through its debt level and the interest burden. Although, this objective limitation cannot be explicitly quantified, the example of Argentina has shown that also countries with a much lower, nearly Maastricht-compliant debt level than the Greek had to declare insolvent (Raffer, 2011). Hence, with a view on this starting situation and bearing in mind the words of German chancellor Angela Merkel who called the rescue efforts *a purchase of time*, the general effectiveness of the current approach with the aim to stabilise Greece may be questioned (FAZ.NET, 2011). The fact that Greece is excluded from the financial markets until today, with no end in sight, makes the claims for an insolvency of the EMU Member State even more oppressive.

The most important question of the debate is: What are the pros and cons of a Greek insolvency? As aforementioned, the ex-post aim of an insolvency procedure is to find a tradeoff between the maximum repayment capacity of the state (with respect to its vital functions) and the financial claims of the creditors. Due to Greece's enormous debt burden, Heinrich (2012) states that a real haircut for Greek government bonds, in terms of debt relief and not only a life extension of the credits, will prospectively be inevitable to regain a sustainable debt level. On the one hand, this would significantly unburden the Greek budget, but on the other hand threaten the solvency of its creditors. Although insolvent states usually still repay a certain share of their debts, Argentina as an example approximately 25 per cent, Russia between 1998 and 2000 about 50 per cent and other countries like Pakistan (1999), Ecuador (1999-2000) and Uruguay (2003) even between 70 and 86 per cent, the officials have to expect also system relevant creditors to get into trouble (Hau & Lucke, 2011). Considering the contagion after the insolvency of Lehman Brothers,

namable experts as well as the aforementioned Managing Director of the IMF plead for an obligatory refinancing of those system relevant credit institutes (Lagarde, 2011; van Suntum & Ilgmann, 2012). According to Hau and Lucke (2011) this practice has three major advantages. Firstly, the rescue packages would only assume liabilities for a small share of creditors, approximately 20 per cent. Hence, instead of guaranteeing the whole credit volume, the Union would only account for those who are likely to threaten the stability of the financial system. Secondly, the community's liabilities are only subsequent because of the banks' equity capital as the preferential source of liability. Thirdly, if this primary source does last out to stabilise the institutes, the community through the refinancing of those institutes purchases claims against the institutes. These claims can be realised when the institutes are stabilised again and might even pay off in profit for the community. Hence, what at first glance obviously seems like a bail-out for credit institutes that are too big to fail could actually become a profitable deal for the taxpayers. Furthermore, the primary liability of the creditors' equity capital also reduces the incentives for risky lending, or in other words the creditor moral hazard. By this the insolvency of Greece would send an unambiguous signal towards the creditors and make them prospectively borrow their money under conditions that respect the default risks. To foster these measures against creditor moral hazard and lower the burden for the community, the EU could moreover consider increasing the equity capital requirements. Nevertheless, in case of countries not able to refinance their banks the Union should still feel obliged to financially support them (van Suntum & Ilgmann, 2012).

Despite these advantages, there are also vehement critics that deem a Greek insolvency to threaten the whole EMU. An important argumentation is that the insolvency (and especially an uncontrolled one) entails unimagined high risks for the stability of the whole eurozone (Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, 2012). The frequently mentioned *domino-metaphor* shall underline the possibility that a Greek insolvency could infect the other crisis-hit countries and maybe also countries like France that are considered to be stable until now (Süddeutsche.de, 2012). This intensification is explained by the fear of investors to suffer damage through further payment default, when investing in other EMU countries.

Indeed, this critique cannot simply be discounted, as the financial markets have proved to react very sensitively on bad news in the past. However, one also has to ask for the consequences of continuing the current approach. As the course of the crisis has unveiled, also the astronomically large amounts guaranteed by the rescue packages were not able to open the way for the crisis hit countries to refund under market conditions again (German Council of Economic Experts, 2011). Rather, the Spanish drawdown of the rescue packages is even an intensification of the problem. By following an approach of continuous enlargement of rescue packages without a clear stabilising effect on the financial markets, the officials equally risk the stability of the whole EMU. Worst case scenarios actually expect bigger economies like Italy or France to begin significantly to totter. The debt volume of Italy, taken by itself, which aggregates to approximately two trillion euro is likely to overcharge the rescue capacity in case of intensive aggravation of the crisis. Those spillovers on the bigger economies of the EMU might be fostered by the uncertainty, resulting for example from the back and forth in context of the elections in Greece, and even endanger the whole eurozone (van Suntum & Ilgmann, 2012).

Further criticism underlines the consequences for Greece and its people. Thus, the insolvency would drive the country into a strong recession which causes essential cuts in the social systems, the exclusion from the financial markets and high unemployment rates (Hau & Lucke, 2011). However, this criticism disregards the fact that Greece already faces a recession, also caused by the austerity programmes imposed by the EU and the IMF (Griechische Botschaft Berlin, 2011). Undoubtedly, an insolvency would enforce further reform efforts, but additionally it would enable the country to relaunch its economy and its whole activities on a sustainable debt level (Kemming, 2007). Moreover, as outlined before, the way to the financial markets is already blocked for Greece. Hence, a sustainable debt level after the insolvency and further reforms could also be interpreted as the key to regain the trust of the financial markets. The disciplinary implications of a restructuring mechanism are likely to emphasise those efforts. To bypass the barred refinanciation after the restructuring procedure, it is imaginable to support the country, under certain conditions, with money from the rescue packages (Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie, 2012).

However, the example of Argentina has shown that a prior highly indebted and uncompetitive country can return to a steadily functioning economy that is, surely after a hard period of reforms, also able to refund itself on the financial markets (Hau & Lucke, 2011).

Respecting the criticism, one important characteristic of the restructuring mechanism stands out: Its controlled and predictable procedure. An uncontrolled insolvency of Greece might very likely let the aforementioned fears become true and intensify the crisis. However, if the attempt to introduce an orderly restructuring procedure succeeds, it will provide the chance for Greece to overcome the crisis and relaunch its economy on a sustainable basis. Considering the current approach's doubtful capability to solve the ESDC and (the even more doubtful capability) to prevent future crises, introducing an orderly procedure and firstly applying it on Greece admittedly entails a certain risk, but overall it seems to be a more convincing approach. Especially the disciplinary implications might help the EU to counteract its liability problem and regain the trust of the financial markets.

## 4. Conclusion

### 4.1. Review of the findings and comparison

The previous chapters have pointed out the main causes for the current European debt crisis. Especially certain structural misfits in the legal framework of the European Monetary Union functioned as an insurance against insolvency and default risks. Thus, they were likely to foster a moral hazard problem on side of the public debtors as well as on side of the creditors. This resulted in too risky lending behaviour and high excessive debt-making. Moreover, the unreliable insolvency risk and the toothless Stability and Growth Pact supported this dangerous process that, together with the financial and banking crisis of 2008, straightly led into the crisis of today.

In chapter two, I underlined the problems concerning the current approach of trying to rescue the crisis-hit countries by assuming liabilities. Not only that this remedy was not able to induce a significant sedation on the financial markets and by this lower risk premiums for crisis-hit countries, it can also be interpreted as the epihphany of the erosion of treaty provisions.

Thereby, it rather fosters the aforementioned moral hazard risk, without creating clear incentives for prospective budgetary discipline. Indeed, further measures like the EFC are supposed to regain the trust in the Member States' discipline, but as long as creditors may expect the purchase of their claims through the rescue packages and as long as the sanction mechanisms for debt sinners do not get automatised, the reliability of these stability declarations will still be raised to question. As a result, the long-term effectivity has to be evaluated as relatively low. Furthermore, the impression hardened that the current rescue packages might be able to delay the insolvency of crisis-hit states for a certain period, but not to completely overcome the current crisis. Hence, also the approach's short-term effectivity may be raised to question.

As the third chapter has shown, an orderly insolvency procedure provides the chance for crisis-hit states to relaunch their economy on a sustainable level of public debt. It enables debtors and creditors to find a tradeoff between the objective repayment capacity and the financial claims. Although, obviously an omnipresent topic in the international system, an orderly insolvency procedure for states is not existent until today. However, the current debate and the aforementioned proposals provide enough ideas to establish such a procedure and within a highly integrated community like the EU its introduction actually seems to be a constitutional imperative. Moreover, the criticism on this approach needs to be respected. Especially the possibility of a domino effect has to be considered. In this regard primarily the *orderly* process of the restructuring is important to prevent the markets from panic reactions and ensure the trust of the creditors. Nevertheless, in opposite to the current approach, an orderly insolvency procedure for the eurozone would send out important signals to guarantee the further stability of the EMU, provide incentives for future budgetary discipline and lower the overall moral hazard problem of the EMU. Thus, the expected long-term effectivity of this alternative approach has to be assessed as high. However, it can also be assumed to be effective in short-term as it returns the insolvent country to a sustainable debt level. This lower debt level might reassure the market's trust in the country's repayment capacity and reopen the way to refinanciation under market conditions. In connection with a strenghtened SGP and measures like the

currently discussed EFC an orderly insolvency procedure might even overcome the EMU's reliability problem and lead it into a sustainable future.

Weighing those aspects against each other, I conclude that the gain of an orderly insolvency procedure, if applied well, is likely to outweigh the gain of purchasing the claims of the crisis-hit countries' creditors. Risks cannot be entirely excluded from both approaches, but the chance to sustainably overcome the current crisis seems to be bigger on side of the alternative approach. Hence, on basis of the prior insights, the answer to the major research question is: *Yes, if it is well applied and predictable.*

Respecting these insights, the officials would do well to reconsider the introductorily mentioned "*alternativlos*"-policy. Now, the most dangerous strategy would be the further delay of the introduction of sustainable measures. Especially the unstable political situation in Greece might potentially foster further mistrust on the financial markets. The last chapter has also outlined the expected benefit of applying the restructuring mechanism on the specific case of Greece. As well as the major research question, the second sub-question thus has to be affirmed. The aforementioned indications, especially concerning Greece's unsustainable debt level, clearly suggest to apply a restructuring mechanism on the country.

All in all, this work has pointed out the high effectivity of the investigated alternative remedy (especially in the long run). As the comparison has just demonstrated, it is likely to be more effective than the currently implemented approach. It is thus irresponsible to dismiss every alternative remedy, and actually the debates on it, a priori from the decision-making process. On basis of the prior insights, I would recommend the introduction of an orderly insolvency procedure for EMU Member States. However, even if the officials will not adopt the alternative approach, this study has shown that they should at least be aware of the different alternatives, its implications and especially the way of evaluating the effectivity of the remedies. By ignoring those insights and maintaining such a narrow-minded position the whole European project might be threatened.

## 4.2. Critical assessment and relevance

Last but not least, the study itself has to be evaluated. To assess the quality of a study and, more specific, its research design, social sciences usually ask for the validity of the findings. Shadish et al. (2002) as well Gerring (2007) differentiate two types of validity, *internal validity* and *external validity*.

Internal validity refers to the question whether an observed covariation reflects a causal relationship. Hence, it is the validity of inference about cause and effect relationships (Shadish et al., 2002). The most important threat to internal validity caused by the use of a single case approach is the impact of third variables. This is also the "*fundamental problem of causal inference*." (Bennet & George, 1997) Whilst randomised experimental designs with treatment and control group as well as pre- and post test allow the researcher to hold third variables stable, the possible impact of unobserved variables in observational, non-experimental research designs, like the case study, cannot be finally excluded. Thus, such observational designs, strictly speaking, do not allow inferences about causality. Nevertheless, as experimental designs are often not feasible for the investigation of a certain phenomenon, large-n approaches try to counter this problem by investigating huge samples of units to make their probabilistic findings more valid (Geschwend & Schimmelpfennig, 2007). The case study design follows another approach. By intensifying the investigation of a single unit, case studies seek to overcome their problems with internal validity. The use of a theoretical background and the aforementioned process tracing method thus allow the identification of causal mechanisms but not probabilistic inferences (Gerring, 2004). However, due to the fact that the researcher cannot fully exclude the possibility that a certain outcome is caused by another causal mechanism than the observed, the problem of *equifinality* must always be considered (Bennett & George, 1997). As a result, the case study design in general and the the design of this study as a specific example will always have at least a hypothetical problem with internal validity. This work tried to counter this problem by a priori identifying moral hazard as a probable cause and the attempt to comprehensively observe the process of the crisis. Nevertheless, one should always be aware of the problems with single-n approaches. Thus, its findings are certainly reasonable, but researchers as well

as EU officials should always consider the whole breadth of possible explanations in their decisions.

The minimisation of problems with internal validity through more detailed observations usually lowers the generalisability of findings, or in other words the *external validity*. Concisely said, external validity asks whether “a causal relationship holds over variations in persons, settings, treatments and outcomes” (Shadish et al., 2002, p. 83). Due to their small-n, Gerring (2004, p. 348) states that case studies “*fall short in their representativeness*”. Gerring's finding holds also true for this study, but they are not only caused by the high intensity of the investigation. Introductorily I mentioned that the ESDC is a unique phenomenon, although it also features similarities to other sovereign debt crises in the past. The generalisation of this study's findings on similar units (Perhaps historic sovereign debt or solvency crises) would be inappropriate. Rather, the findings are peculiar to the unique setting of a highly integrated community like the EMU. Furthermore, also the findings concerning the remedies' effectivity can hardly be generalised. Settings are conceivable in which also the funding of a crisis-hit country might be a appropriate remedy to overcome a solvency crisis. This assessment always has to be done with respect to the specific setting and the origin of the given crisis. However, as this work primarily aimed at solving a specific problem in the specific context of the ESDC, it may be questioned whether a lack of representativeness is a point to criticise.

It was not the declared aim of this study to come to generalisable findings. As abovementioned, it provided significant insights concerning the causal mechanism that led into this crisis. Although, problems with internal validity cannot be neglected, this study has shown that especially the theoretical concept of moral hazard serves consistent explanations. Although this study did not overhaul or refine the model, its application on the ESDC highlighted the practical value of this specific rational choice approach. The identification of the possible causal mechanisms that brought the crisis and the further assessment of the remedies' effectivity led to a concrete and reasoned suggestion for the further handling of the crisis, even if, as aforementioned, the fundamental problem of causality should always be kept in mind. The introductory expectation of this thesis' high practical value may feel vindicated. It is thus highly interesting to observe the further course of the ESDC and investigate,

whether the findings of this work, primarily concerning the approaches' expected effectivity, can be confirmed in reality.

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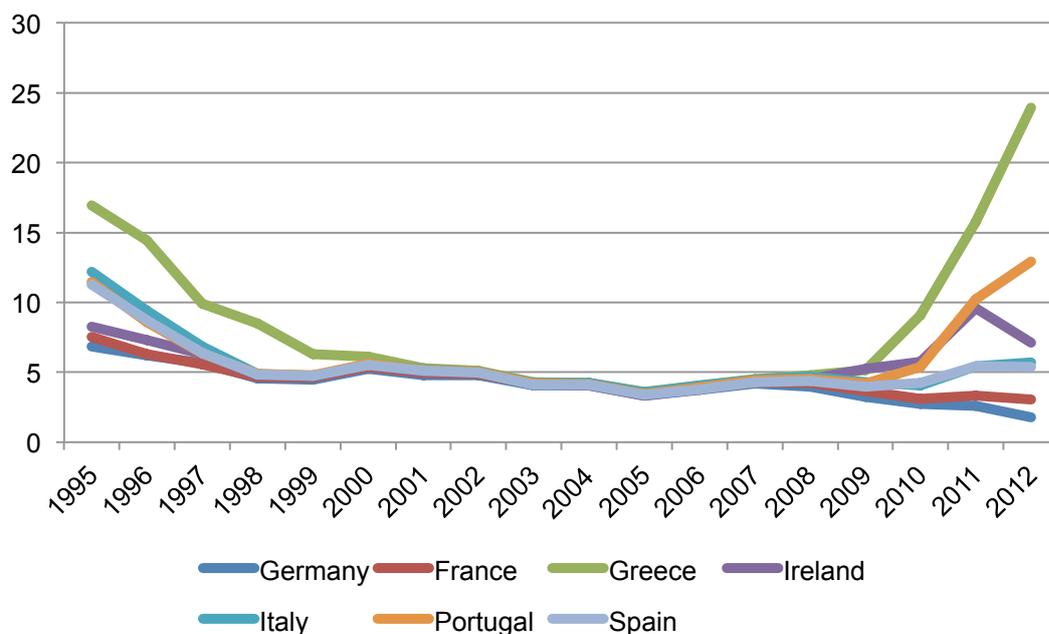
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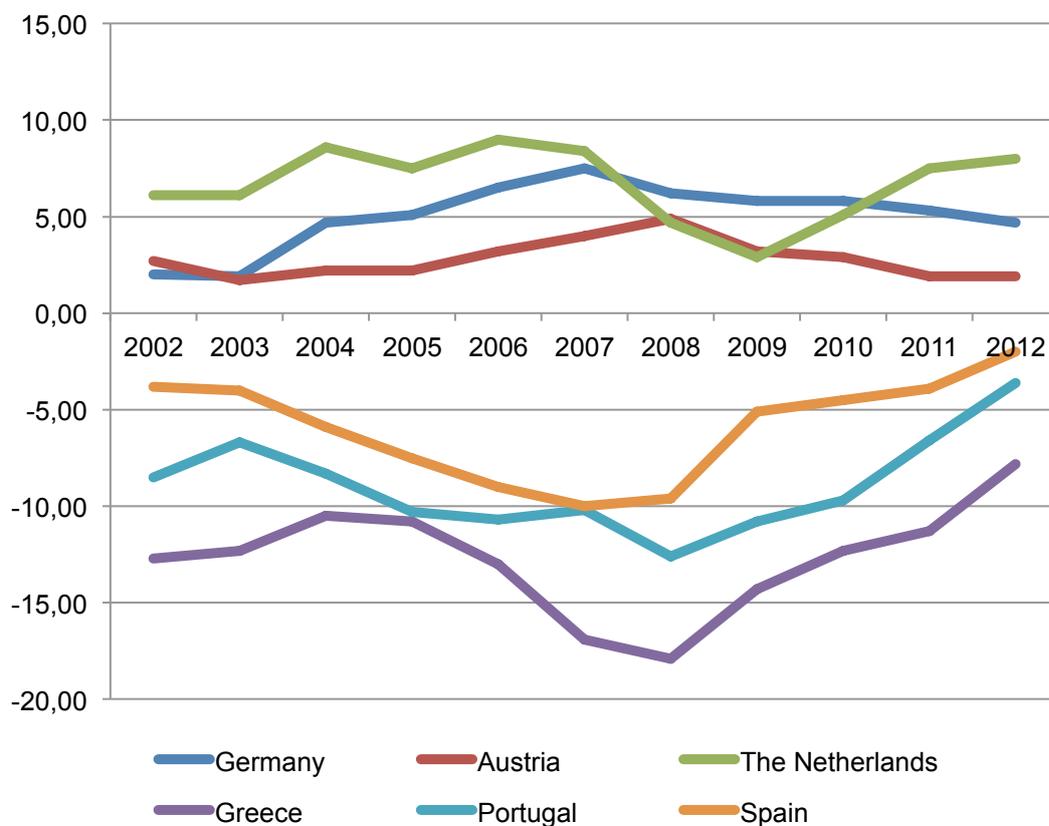
# Appendix

	<b>AUS</b>	<b>GER</b>	<b>FR</b>	<b>GR</b>	<b>IRE</b>	<b>IT</b>	<b>POR</b>	<b>SPA</b>
1995	7,13	6,85	7,54	16,96	8,26	12,21	11,47	11,27
1996	6,32	6,22	6,31	14,43	7,29	9,40	8,56	8,74
1997	5,68	5,64	5,58	9,92	6,29	6,86	6,36	6,40
1998	4,71	4,57	4,64	8,48	4,80	4,88	4,88	4,83
1999	4,68	4,49	4,61	6,30	4,71	4,73	4,78	4,73
2000	5,56	5,26	5,39	6,10	5,51	5,58	5,60	5,53
2001	5,08	4,80	4,94	5,30	5,01	5,19	5,16	5,12
2002	4,96	4,78	4,86	5,12	5,01	5,04	5,01	4,96
2003	4,14	4,07	4,13	4,27	4,13	4,25	4,18	4,12
2004	4,13	4,04	4,10	4,26	4,08	4,26	4,14	4,10
2005	3,39	3,35	3,41	3,59	3,33	3,56	3,44	3,39
2006	3,80	3,76	3,80	4,07	3,77	4,05	3,92	3,79
2007	4,30	4,22	4,30	4,50	4,31	4,49	4,43	4,31
2008	4,36	3,98	4,23	4,80	4,53	4,68	4,52	4,37
2009	3,94	3,22	3,65	5,17	5,23	4,31	4,21	3,98
2010	3,23	2,74	3,12	9,09	5,74	4,04	5,40	4,25
2011	3,32	2,61	3,32	15,75	9,60	5,42	10,24	5,44
Jan 12	3,27	1,82	3,18	25,91	7,71	6,54	13,85	5,41
Feb 12	3,00	1,85	3,02	29,24	7,02	5,55	12,81	5,11
Mar 12	2,87	1,83	2,95	19,07	6,9	5,05	13,01	5,17
Apr 12	2,83	1,62	2,99	21,48	6,88	5,68	12,01	5,79

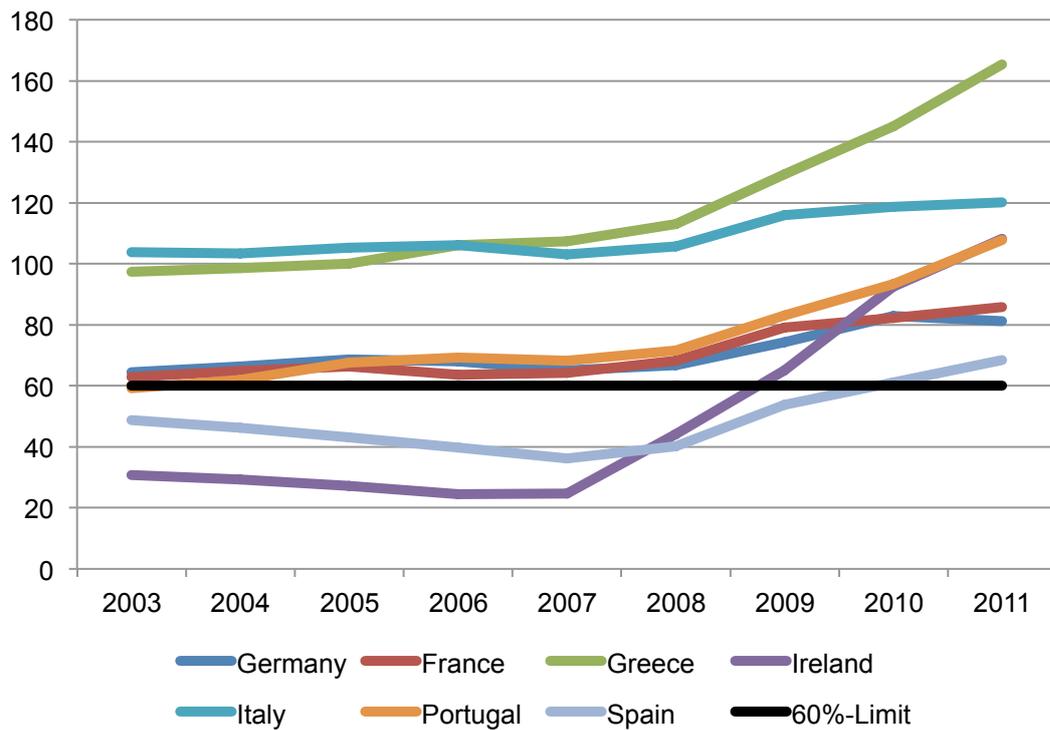
**TABLE 1:** Long-term interest rates on government bonds of selected countries between 1995 and April 2012 in per cent (Data source: European Central Bank, 2012)



**FIGURE 1:** Long-term interest rates on government bonds of selected countries between 1995 and April 2012 in per cent (Own Graph; data source: European Central Bank, 2012)



**FIGURE 2:** Balance of trades surpluses and deficits of selected countries between 2002 and 2012 in per cent of GDP (Own graph; data source: Wirtschaftskammer Österreich, 2012)



**Figure 3:** Gross debt of selected countries between 2003 and 2011 in per cent of GDP (Own graph; date source: Eurostat, 2012)