ECONOMIC GOVERNANCE

Sovereign Debt Crisis Resolution in the Eurozone[1]

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Searching for a comprehensive solution to the eurozone debt crisis

In the past two years, the countries most affected by sovereign debt crises – Greece, Ireland, Spain and Portugal – have announced and started implementing consolidation plans and economic reforms. These countries share common characteristics and problems (mainly high private and / or public debt and low competitiveness), but Greece stands apart among them because of the seriousness and the nature of its woes. With a debt-to-Gross Domestic Product (GDP) ratio scheduled to exceed 150%, the country is on the verge of insolvency. Also, the public debt predicament has arisen mainly as a consequence of public finance mismanagement, while banking problems have played a secondary role (in the case of Ireland and Spain, the situation is reversed).

This assessment is confirmed by the forward-looking evaluation undertaken in Darvas et al. (2011). This analysis shows that even under the most optimistic hypotheses, the adjustments to public finance that would be needed to stabilise debt at its 2015 level or to meet the Maastricht criteria of 60% in 2034 are of a frightening magnitude both in the case of Greece and Ireland. Even more worrying for Greece is the size of the primary surplus that would need to be maintained over a period of years to achieve a return to safe levels of public debt: more than 8% of GDP in an optimistic scenario and more than 14% in a cautious one. Over the last 50 years, no Organisation for Economic Co-operation and Development (OECD) country (except oil-rich Norway) has sustained a primary surplus above 6% of GDP for a meaningful period of time. Our conclusion, therefore, is that Greece has become insolvent. The same does not hold for Ireland, where the necessary primary surplus remains within the range of what has been achieved historically, or for Spain and Portugal where the required adjustment is lower.

There does exist a form of middle-way between adjustment and restructuring: a lowering of the interest rate charged on all official EU loans, an extension of the maturity on official EU loans (and possibly on the International Monetary Fund (IMF) portion of the Greek rescue package), and the repurchase of all government bonds currently held by the European Central Bank (ECB), with the retrocession of the haircut to the issuing country. In March, the European leaders agreed on the former, but did not contemplate the latter. However, even assuming all three measures are implemented and a positive market reaction, this would still be grossly insufficient to restore solvency in Greece. Estimates suggest that a further 30% haircut would be required to ensure long-term sustainability.

This is the kind of estimate economists can come up with. We do not claim, however, that our numbers are definitive. What we do claim is that the presumption of insolvency is sufficient to necessitate a comprehensive sustainability assessment. For such an assessment to be accurate, however, the situation of the banking sector has to be clarified.

On the basis of the above evidence, it appears that a significant reduction of Greek debt is needed. As the share of official creditors will rise with time (and that imposing losses upon them appears politically unpalatable), the size of the haircut required to restore sustainability will rise as well. Moreover, delaying is likely to weigh on growth and create the risk of a negative feedback loop with respect to public finances. For these reasons, restructuring should happen sooner rather than later.

One of the main obstacles to a rapid resolution of the eurozone crisis is, however, the difficulty policymakers have in tackling spillover effects, both between banking and sovereign difficulties and across countries. Our estimates indicate that the spillover from a sustainability-restoring haircut on Greece (aggregate losses in the range of €35 billion) would be manageable. Some banks would need recapitalisation and the impact on the public finances of other eurozone countries would remain limited – certainly they would be limited in comparison to total aggregate losses from the subprime crisis, which the IMF puts at €500 billion for the whole of the eurozone.

The dire financial situation of sovereigns is, however, only one of the facets of the eurozone crisis. In the case of Ireland and Spain, it is uncertainty over unrealised losses in the banking sector that is cause for concern. This was supposed to have been addressed by the European stress tests in July 2010, but the subsequent developments in Irish banks have discredited the exercise. The implementation of new and this time rigorous and credible stress tests is therefore an absolute priority for the euro-area and a precondition to addressing sovereign solvency.

1. This paper draws on François Gianvitti, Anne Krueger, Jean Pisani-Ferry, André Sapir and Jürgen von Hagen, "A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal", *Bruegel Blueprint Series N°10,* 9 November 2010, available at: http://www.europolitique.info/pdf/gratuit_fr/282201-fr.pdf – and on Zsolt Darvas, Jean Pisani-Ferry and André Sapir, "A Comprehensive Approach to the Euro-Area Debt Crisis", *Bruegel Policy Brief N°2011-02*, 8 February 2011, available at: http://www.bruegel.org/publications/publication-detail/publication/496-a-comprehensive-approach-to-the-euro-area-debt-crisis – We are grateful to Christophe Gouardo for his help in preparing it

Because EU supervisors squandered credibility in the previous round of stress tests, it would be highly desirable to involve the IMF and possibly the Banks for International Settlements (BIS) in the next round. Once these tests have been carried out, eurozone countries should immediately proceed with restructuring where necessary, which should imply the recapitalisation of viable institutions and the closure of non-viable ones. As well as helping to stem contagion to other countries, this strengthening of the banking sector would help to limit the downside risks for the financial system that would arise from a restructuring of Greek debt.

The absence of contingency plans

One of the reasons for the high volatility during the crisis was the absence of contingency plans to deal with sovereign debt problems. The crisis revealed a gap in a policy framework that focused exclusively on prevention and included no provision for crisis management and resolution. Whatever the outcome for the current difficulties, it is clear that no set of fiscal rules, however well enforced and however well designed, will eliminate the possibility of future debt crises. Additionally, the crisis has shown that sovereign debt crises are not the sole preserve of developing and emerging countries.

As we have seen in the case of Greece, there can be situations where the debt burden is such that the required retrenchment would be economically unrealistic, not to mention politically unfeasible in democratic states. Outright bailouts are naturally out of the question, as the treaty makes clear that each Member State is only responsible for its own liabilities, leaving restructuring as the only exit from an unsustainable level of debt.

Two arguments are traditionally put forward against allowing for sovereign debt restructuring within the eurozone. The first is that, as eurozone government bonds are mostly held by eurozone residents (and particularly banks), the losses from a restructuring could jeopardise financial stability. This is an important concern, though a transitional one. Banks exposed themselves to Greek debt under the assumption that it was risk-free. Once banks have become familiar with the new regime and price risk accordingly, they will adjust their exposures to sovereign risk. Moreover, consistency of regulatory policies would imply that banks be required to hold capital against public debt.

The second argument is that the mere creation of a sovereign-debt resolution mechanism could have negative effects on the borrowing costs of other Member States because it would signal, for the first time since World War II, that advanced countries' government debt securities are not safe assets. It is true that the reputational spillover effects of a default within the euro area cannot be taken lightly. But the existence of a procedure would in fact only open the possibility of reasonably orderly defaults, instead of only 'bad and ugly' ones.

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In the event of a future debt crisis, a debt restructuring mechanism would go a long way towards avoiding market turmoil – this is because the mechanism would guide market expectations about the steps that would be taken and their likely outcomes. In establishing clear rules for involving creditors, it would also create stronger incentives to care about the creditworthiness of sovereign debtors ex ante and thereby strengthen market discipline.

Designing the European stability mechanism

Sovereign defaults are different from private defaults in a number of ways. The first is that, in contrast to a private company, the sovereign entity cannot be dissolved, a forced liquidation of its assets is impossible, and its creditors cannot assume ownership. This implies that a debt restructuring procedure, if it exists, must be invoked when the sovereign debtor declares itself unable to pay its debt service.

Second, while a private bankruptcy procedure primarily aims at maximising the value the creditors can extract from the defaulting institution, a defaulting sovereign must be left with the financial means to perform at least minimal functions of government. The only sensible goal of the procedure should be to restore the sustainability of the sovereign's public finances.

Third, under democratic government or a community of democratic states, it is inconceivable that a government be put under receivership, because this would contradict the nature of democracy.

Fourth, evaluating solvency requires a judgement on the possibility for the sovereign to levy taxes and repay its debt. This generally involves an economic, but also a political assessment of the size of the primary surplus that can be attained and maintained in a given context.

These differences imply that the instruments to deal with sovereign-debt crises in an orderly way are more limited than in the case of private debt. A procedure must be found to restructure the debt in an orderly fashion through negotiations with the creditors. For the eurozone, such a framework would have to have four main elements:

- First, a formal way to initiate the debt-resolution procedure. The initiative to start the procedure can only come from the debtor government. With the opening of the procedure, the country would immediately stop servicing its debt to national and international creditors and there would be a stay on all litigation by individual creditors seeking repayment.
- Second, a mechanism to prevent a minority of bondholders from exploiting the majority by refusing to agree to a restructuring of the debt in the hope that the majority would buy them out. This requires that a super-majority of bondholders can outvote the minority in the decision to enter into negotiations and to conclude agreement with the debtor country regarding a restructuring of its debt.

- Third, a mechanism to conduct negotiations. In civil bankruptcy procedures, this is the role of the court-appointed trustee. In the context of sovereign default, the sheer size of the task implies that it would have to be assumed by a neutral, politically independent body.
- Fourth, a rule for the provision of fresh credit from the EU or other euro-area Member States to the government in financial distress. In the past, sovereign defaults have often been accompanied by periods during which the defaulting government no longer had access to credit markets.

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

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

Our view is, however, that the contractual approach has severe limitations and is perhaps even unsuited to the European case. The reason is that it is intended to facilitate the negotiation of a settlement between a country and its private creditors, whereas the default of a eurozone country might raise concerns over financial stability in the eurozone as a whole. This would necessarily lead the governments of the affected countries to step in, thereby transforming the negotiation between a country and its private creditors into a *de facto* international negotiation involving states.

Therefore we have been advocating the statutory approach[2], which allows aggregation across all creditors' claims, and have proposed the creation of a European Crisis Resolution Mechanism (ECRM). We have suggested that the ECRM should involve three separate bodies: a legal one in charge of adjudication and conflict settlement, an economic one to provide the necessary economic expertise and judgement, and a financial one dealing with financial assistance.

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

2. Gianvitti *et al., op. cit.*, 2010

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After the formal opening of the procedure, **the economic body** would have the task of calling for meetings of the borrower and the lenders and of guiding the negotiations with a view to finding a solution acceptable to both sides. To fulfil this task, it would have i) to be able to review the economic and financial accuracy of a borrower's representation of its economic and financial situation and perspectives; ii) to evaluate the implications of any restructuring proposal for the borrower's outstanding debt (i.e. the extent of the haircut) and its sustainable level of debt going forward (i.e. the projected future path of primary budgetary surpluses). These functions require that all parties trust that the judgment of this body be not only neutral but also 'fair'.
The economic body would have the responsibility of assessing when a country is truly unable to meet its future financial obligations and by how much its debt needs to be reduced to solve that problem. There can be no simple test or rule for doing this, because a government can legally use its taxing powers to reduce citizens' income and make room for servicing the debt. Reliance on judgment will therefore be inevitable. But what is crucial is that such judgments are coherent across time and countries and that they are based on sound principles.

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

Various institutional arrangements can be conceived as regards the assignment of the legal, economic and financing functions of crisis resolution, but whatever the arrangement, these three roles should be fulfilled and distinguished in order to avoid creating conflicts of interest. Our suggestion is that the legal role would be assigned to the Court of Justice of the EU, to a specialised chamber within the court or, if preferred, to an entirely new institution. The economic role should be given to an independent institution capable of providing the required assessment and of keeping a stance throughout the negotiations between creditors and debtor, if the extent of the assistance becomes an argument in negotiations. This role should in our view accrue to the European Commission or to the European Commission jointly with the ECB. Finally, the natural choice for financial assistance would be the European Financial Stability Facility (EFSF), which would thus need to be made permanent and be given preferred creditor status, as envisaged for the European Stability Mechanism (ESM).

The statutory solution is more ambitious than the contractual one and it is for this reason that the latter has been chosen for the ESM. It should nevertheless be regarded as a reference, the principles and procedures of which should, as much as possible, be mimicked in a less ambitious system. Especially, the three roles – legal, economic and financial – should be distinguished and assigned to existing or newly created bodies.