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Sovereign Bankruptcy in the EU in the Comparative Perspective

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1. Introduction

Given the current fiscal situation in Greece, much attention is attracted to the issue of the sovereign bankruptcy in the eurozone, or – more broadly – in the EU. However, it is difficult to discuss this problem in a sensible way, without first analyzing some wider questions. This is why I start this paper with some brief remarks on the types of the sovereign debt distress (section 2). Section 3 deals with the main causes of the sovereign debt distress and their economic consequences. As they can be very serious, one must discuss how the alternative sovereign debt resolution mechanisms influence the behavior of the sovereign debtors and their creditors and, as the result, the probability of the sovereign debt crises. In section 4 I use the existing literature to present the main types of the sovereign debt resolution mechanisms. I compare the sovereign bankruptcy with other debt resolution mechanisms, both from the ex post and ex ante point of view. Section 5 deals with the debt distress and debt resolution problems in the EU, especially in the eurozone. Section 6 concludes.

2. Types of the Debt Distress

Debtors and creditors are the roles played by various types of entities, which conclude the debt contract. The debtor (as well as the creditor) could be: a physical person, a non-financial company, a financial company, especially the deposit-taking bank, a non-economic organization (e.g. an association), a municipality or a state within a sovereign country, and finally – the sovereign. Each of those units can run into a debt distress which I define broadly

as any situation when the debtor has problems with servicing the debt and/or paying back the capital according to the original schedule.

There are different types of debt distress situations which call for different debt resolution mechanisms.

The classical – and important – distinction is between illiquidity and insolvency. In the former, the debtor is capable of servicing and paying back the debt according to the original schedule but runs into some short-run difficulties. Therefore, some short-term liquidity assistance is in order. In the latter, the debtor is not capable of doing that, thus some debt restructuring (changing the time profile of debt payment) or debt reduction is called for.

This distinction matters very much especially in the case of debt distress faced by two types of debtors: the banks and the sovereigns, as the wrong diagnosis *ex ante* and the ensuing application of the wrong debt resolution mechanisms may prolong the crisis instead of solving it. What I have especially in mind is misdiagnosing the liquidity problem while the true situation is insolvency. In the case of banks resulting liquidity assistance from the central bank would delay the necessary restructuring of their balance sheets and thus prolong the accumulation of non-performing loans which culminates in a deep credit crunch, hurting the economy. This policy error is widely believed to have been committed in Japan in 1990's. Some authors believe that it was also made in the US during 2008-2009 (J.B. Taylor, 2009). The reverse error: confusing the liquidity shock with the insolvency situation of the banks is probably less frequent (and perhaps less harmful), as the political and situational pressures are rather focused on liquidity assistance. However, if committed, it unnecessarily engages the administrative and financial resources of the intervening parties and is likely to lead to an increased moral hazard on the part of the debtors.¹

Let me now turn to the sovereign debtors. Also in their case, it is not easy to make the *ex ante* distinction between the liquidity shock and the insolvency crisis (for the definitions of both situations, see Roubini, 2002, Kumar et al, 2005)

What is usually meant by sovereign insolvency is the government longer term inability to service and or pay back the debt. Or in other words ‘a country debt level is unsustainable’ (R. Rajan, 2005, s. 20), and, thus, some debt reduction is necessary. However, it is difficult to distinguish a sovereign inability to pay from his unwillingness to do so. Rajan (2005, p. 20)

¹ In practice, the recent interventions of the central banks which consisted in injecting liquidity into the banking sector against the increased set of collaterals might have contained some component of the asset restructuring of the banks. (I owe this remark to Jerzy Pruski)

distinguishes between solvency shock and conditional solvency shock. In the former the level of debt is “simply unsustainable” in the latter “the country needs to undertake structural reforms to maintain solvency in the face of a shock, but would be solvent, and would regain the confidence of international capital markets, conditional on undertaking those reforms”. This implies that there are some hopeless cases where no reforms (and or macroeconomic adjustment) can help a country to regain solvency, and other cases where there are some reforms (or adjustments) which, if implemented, would restore a country’s solvency. It appears, however, that from the economic point of view there are almost always some packages of macroeconomic adjustment and structural reforms which, if launched and sustained, would make a country in debt distress capable of servicing and paying back the debt, i.e. avoiding the debt reduction.²

Therefore, from the purely economic point of view, a country’s inability to pay, i.e. its insolvency is an almost empty concept (cf Reinhart and Rogoff, 2009). The empirically more relevant questions are, first, whether the package of adjustments – reforms which would restore a country’s solvency, if implemented, is desirable and second, whether it is possible from the socio-political point of view to launch and sustain.

The desirability issue is about why the burden of macroeconomic adjustment³ necessary in the face of a large debt burden must fall exclusively on the shoulders of the sovereign debtor and not touch the creditors. (The same question is obviously true of other debtors, too), It is therefore, about the “burden sharing” between the creditors and the debtor: A huge debt burden results from the decisions of both a debtor and its creditors and – so the story goes – both sides should be responsible for its resolution. And the evolution of the legal mechanisms to deal with the debt distress of companies or individuals within the respective countries went from the exclusive responsibility of the debtor in 19 century towards the shared responsibility of both sides: debtor and its creditors. With respect to the sovereigns it is especially the odious debt, i.e. the debt inherited from the previous and oppressive regime, which especially invokes the issue of the desirability of some debt reduction (ct: Rogoff and Zettelmeyer, 2002).

The second question, that of the socio-political feasibility of the adjustment – reforms package which, if implemented , would make a country solvent, deals with several issues.

² Some debt restructuring, i.e. changing the profile of payments may be needed in case of even most radical adjustments.

³ A stake is much more the issue of macroeconomic adjustment which aims at reducing the domestic spending than the structural reforms which would enhance a country long-run growth.

One is whether the country's government is capable of passing and enforcing the required package, another and- related one – are risks of social protests, demonstrations, riots, etc. And the third one is that the government may be in fact unwilling to take sufficient socio-political risks while claiming that it is incapable of introducing the necessary adjustment because of the socio-political constraints it faces. In other words it is not easy to distinguish empirically a sovereign debtor unwillingness to pay from its true inability to do so. In trying to do so one must engage in an analysis of the socio-political peculiarities of the debtor country, but by doing this one can easily fall in to a trap. The trap is that countries with more populist socio-political structures, say, a larger role of militant trade unions, would get a more lenient treatment than those where the socio-political environment is judged more conducive to the necessary economic adjustment and reforms. Such double standards may appear when the debtor countries are seeking the conditional crisis lending from the IMF or – in the case of the EU members – from the EU institutions. Applying such standards would not only be unfair, because the populist structures would be sort of rewarded, but also counterproductive in the longer run as the demanded package of adjustment and reforms in the countries with populist socio-political structures could easily fall short of that which is capable of solving their economic problems in a more lasting way. If the crisis lender wants to avoid this trap it should demand what is economically necessary from the debtor countries, and, thus, largely disregard their socio-political peculiarities. However, while choosing this course of action, he should know and accept in advance that this strategy may in fact cause various social protests in countries with more populist socio-political structures. And by “accepting” I mean persisting with the original demands as long as they are economically justified.

The above passage can be easily illustrated with a recent real-life example: The Baltics, Hungary or Ireland have recently launched radical economic adjustments which appear to be positively recognized by the international financial markets. Shouldn't Greece be expected to implement similar adjustments even if its socio-political characteristics differ from those in the former countries?

Let me now turn to what is behind the sovereign debtor's willingness – or unwillingness – to pay. Any deeper discussion of this issue should specify:

1. Who is the sovereign, i.e. who are the relevant decision –makers who represent the “sovereign”, and – related to that: 2. What are their utility functions, (or – to put it simply – what do they care about), and what are the situational (including institutional) factors which determine their feasible set, i.e. the set of actions, perceived as feasible by the decision-makers. Based on that one would know the relative expected utility of the options contained

in the feasible set in the eyes of the relevant decision-makers; in our case – the utility of continuing to service and pay back the debt according to the original schedule relative to the utility of other options: seeking more or less voluntary debt restructuring or debt reduction, possibly coupled with some third party assistance, or unilateral default. Such a model of the rational choice applied to a sovereign in debt distress must go well beyond the typical analytical treatment of a debt-distressed sovereign as the benevolent social planner bent on maximizing the social welfare in an infinite time horizon. In other words, the old-fashioned welfare economics perspective should be replaced by the public choice or –more broadly–the neoinstitutional economics approach, where the decision of the sovereign are explained by means of the general model, which includes the decision-makers choice situation and his (her) cognitive and motivational characteristics (for more on this see: L. Balcerowicz, 1995). In trying to apply this model to the issue of the sovereign’s willingness (or unwillingness) to pay one must obviously, consider the nature of the debtor countries’ political regime. In an entrenched dictatorship a dictator who is a control-freak and – as a result – is unwilling to enter any negotiations with the external creditors⁴, will be willing to pay, i.e. willing to impose very harsh adjustment program on its own people. An arch example is drastic adjustment imposed by Ceausescu on the Romanians in the 1980. Rulers in the fragile democracy, faced with the same serious debt distress, are likely to be less willing to pay, i.e. less willing to accept a harsh economic adjustment, which means that they would prefer other options: debt restructuring or debt reduction, possibly associated with same crisis lending. In other words, they would prefer protests from the financial markets to the protests from their own people. However, things get more complicated if some of the own people or institutions are creditors to government. This brings me to the next issue.

Not only the nature of political regime influences the sovereign’s willingness to pay but also the composition of the public debt. The financial liberalization of the last 20 years has blurred the traditional distinction between the domestic debt (i.e. denominated in domestic currency, based on the local law, sold to the residents) and foreign debt (foreign currency, foreign law, non-residents). On the one hand, the residents hold nowadays some foreign currency, foreign law debt, on the other – non-residents hold some local currency, local law debt securities (Gelpern and Setser, 2004).

⁴ A dictator who is less inclined to keep absolute power (or who is less entrenched in power) would be less willing to pay, i.e. more willing to seek some debt restructuring or debt reduction. This is one indication among many that under dictatorships personality differences among the rulers matter, and they matter more than under limited governments.

These developments have complicated the separation of the public debt from that owned by the non-residents. However, the difficulty differs from case to case. The separation turned out to be possible in Russia past 1998 and in Argentina past 2001; in both these cases the domestic creditors, especially the banks, obtained a better deal than the foreign ones. That separation was found to difficult in Turkey in 2001. As a result, the government chose the option of continuing to service the public debt owned by all the creditors (Gelpern and Setser, 2004)

3. The Causes and Costs of the Sovereign Debt Crises.

Serious sovereign debt crises stem from two major domestic sources:

1. the Persistently and highly expansionary fiscal policy i.e. accumulation of budgetary deficits and –as the result – the increasing ratio of public debt to GDP;
2. The banking crisis which sharply increases the public debt both due to the costs of bailing out the banks and – even more – due to the recession which follows such a crisis (see: Reinhart and Rogoff, 2009)

Sovereign debt crises also result from external shocks, i.e. global financial crises or sharp worsening in a country's terms of trade ⁵. However, the impact of such shocks is, other things being equal, the stronger, the larger were the domestic economic vulnerabilities: unsustainable fiscal position or excessive private debt, which stimulated the asset bubbles that burst. This link between the impact of the external shocks and the domestic vulnerabilities has been amply demonstrated by the recent global financial crises. Among the most affected European economies, Greece, Hungary, Britain illustrate the dangers of the sovereign debt problem due to highly and persistently expansionary fiscal polity, while Spain, Ireland, the Baltics, and – again- Britain show the dangers of the housing bubbles, which went bust.

Serious sovereign debt crises (and/or the related financial crises) are socially costly because they lead to the output losses – relative to a smoother trajectory of economic growth. Those losses are incurred during the recession which is brought about by the crisis. In addition some crises may impair the longer forces of economic growth. This important issue is underresearched but the existing literature suggest that such a danger exist (see, e.g, Cerra, Panizza, and Saxena, 2009). One of the possible channels is the political one: the public, inflamed by the media and the politicians, may blame the market forces for the crisis which in fact was caused by the public policy errors and the lack of structural reforms. If this is the

⁵ Another reason are wars which typically lead to huge public debts.

case, than the resulting statist policies would weaken the forces of long-run growth (Balcerowicz, 2010)

As serious debt and –the related –financial crises are socially costly it is natural to inquire what are the factors which make them more or less likely. This fundamental issue is, obviously, beyond the scope of this paper. I would only mention that – at the sufficiently deep level of analysis – one needs to look again at the political regimes, i.e. at the strength of the constraints and the nature of incentives faced by the public policy-makers. Depending on these variables (and on personality factors) catastrophic or persistent policy errors are more or less likely. (For more on this: Balcerowicz, 2008).

While leaving aside the problem of the fundamental causes of the serious debt crises, let me stress that in discussing the next topic: the alternative debt resolution mechanisms, we must consider how they influence the probability that such crises would arise in the first place, i.e. how do they shape the incentives of the sovereign borrowers to borrow and those of the lenders to lend. This is the issue of moral hazard or ex ante analysis which should not be forgotten when assessing the strengths and weaknesses of various ways of coping with the sovereign debt crises which already occurred.

3. Debt resolution mechanisms

Debt resolution mechanisms are schemes of actions which can be applied by the debtor and/or by the creditor when debt distress arises. What mechanism is applied depends on the type of the debtor, on the type of the creditor and on what is the debt distress situation. In certain debt distress situations a sequence of successive debt resolution mechanisms may be applied. For example, if the liquidity assistance fails because the problem turns to be the excessive debt burden, some debt restructuring or debt relief will be applied, sooner or later.

Table 1. Pairs of creditors and borrowers.

| Debtor Creditor | Physical person | Non-public organization especially the banks | Municipal or regional subunits of a country | The sovereign | International public financial organizations |
|--|------------------------|---|--|------------------------|---|
| Physical persons | 1. frequent | 2. frequent | 3. frequent | 4. frequent | 5. frequent |
| Non-public organizations especially the banks | 6. frequent | 7. frequent | 8. frequent | 9. frequent | 10. none |
| Municipal regional subunits of country | 11. none or rare | 12. frequent | 13. Rare | 14. none or rare | 15. none |
| The Sovereign | 16. rare | 17. central banks liquidity operations | 18. Crisis assistance | 19. Official creditors | 20. None or rare |
| International public financial organizations | 21. None | 22. Investing the funds in the financial markets | 23. None | 24. Crisis lending | 25. None |

Table 1 lists the theoretical pairs of creditors and debtors. As one can see only some of them occur in reality. Focusing on the sovereign debtors we see that they may have four kinds of creditors:

1. Physical persons as holders of sovereign's bonds, both residents and non-residents.
2. Non-public organizations as holders of such bonds or providers of credit to the sovereigns (banks), both residents and non-residents.
3. Other sovereigns (official lending)
4. International public lenders of last resort (IMF, EU institutions with respect to the members of the EU). Categories (1) and (2), taken together, make up the financial markets as creditors of the sovereigns. .

Official lenders guarantee the expert creditors or engage in direct lending to other sovereigns. Their behavior towards the sovereign borrowers in distress is unavoidably influenced by their foreign policy and geopolitical considerations (Sachs, 2003). Paris Club,

in existence since 1956, is the official but informal (i.e. not based on a special international treaty) forum for coordinating the policies of the sovereign creditors with respect to their sovereign borrowers which are in debt distress. I leave this issue aside, as the official lending to the sovereigns has been declining in importance relative to the private one. Besides, it is the latter which is the focus of the discussions on the alternative debt resolution mechanisms, including the issue of the desirability, structure, feasibility and of the sovereign bankruptcy. I should add, however, that with respect of countries with a high share of public debt it was the Paris Club which had played the leading role – both in the chronological and substantive sense – regarding the debt restructuring or debt reduction.⁶

A look at the practice of dealing with sovereign distress and at the relevant literature shows that one can distinguish four classes of debt resolution mechanisms:

1. Pure market solutions, also called by some authors laissez-fair approaches (Roubini, 2002). They include both unilateral defaults⁷, debt buy-backs by the debtor on the debt market (Velasquez, 1996) and more or less voluntary debt restructuring or reduction, based on the negotiations between the debtor and creditors⁸. Negotiations may, if successful, prevent the default or be conducted after this event.

2. Modified market solutions, called by some authors “contractual” approaches (Roubini, 2002) or “orderly workouts without a bankruptcy court” (Rogoff, Zettelmeyer, 2002). They result from a sort of public-private partnership and have a form of modifications of the debt contracts, the modifications which aim at improving the coordination between the creditors in their dealings with the distressed sovereign debtor and thus to reduce the collective action problems among them. The main example of the modified market solutions are the collective action clauses (CACs) increasingly introduced into the bond contracts issued by the sovereigns since the early 2000 (Progress Report..., 2005). This tendency resulted from the interaction between the representations of the financial institutions and the governments of the major countries (see: Rogoff and Zettelmeyer, 2002)

One could perhaps also classify the Brady Plan, applied in 1990’s under the modified market solutions category. The difference relative to CACs is that more political pressure was

⁶For example in the case of Poland, which inherited from the socialist regime, a heavy foreign debt burden, 2/3 of which was due to the official creditors, the Paris Club decided in 1991 to grant Poland the debt reduction in the range of 50 percent in net present value terms. It was followed in 1995 by a similar debt relief from the private banks represented by the London Club.

⁷The default occurs according to the financial market definition “when the sovereign has missed either a coupon, or a principal payment, inclusive of the grace period (Singh, 2003)

⁸Trebesch (2009) proposes new empirical measure of cooperative versus conflictual crisis resolutions mechanisms and limit sit to the costs to the domestic firms.

probably applied in the case of the Brady Plan (see: Velasquez, 1996) and that it was a one-time initiative while the CAC's are meant – and are likely – to be the permanent feature of the sovereign bond contracts.

3. The assistance from the IMF. It traditionally has consisted in the crisis lending, conditional on the sovereign debtor's agreement to introduce policy changes that, if implemented, would hopefully remove the causes of the debt distress. The conditionality lending aims at dealing with the liquidity crises caused by contagion (creditors' panics), by external shocks and/or by expansionary policies of the sovereign lender. The critics of the traditional IMF crises lending stress that in practice the IMF support amounted to the bail-out of the creditors thus increasing the moral hazard among them and burdening the debtor country with the excessive adjustment costs or that the content of conditionality was improper, or that the IMF has tolerated the non-fulfillment of its conditionality by repeatedly lending to the same countries (surveillance failures).⁹

Partly in response to some of these criticism the IMF started to “lend into the areas” (Rogoff and Zettelmeyer, 2002) thus allowing the possibility that its assistance would not only deal with the liquidity crises but also with those which happen after the default and may involve some debt restructuring or debt reduction.

Another response to the criticism has been the opening of the credit lines to those countries which are judged by the Fund to have been carrying out sufficiently sound policies. This scheme of lending is thought to have better incentive properties than the traditional one as it depends on the past policies and not on the promised ones. However, the global financial crisis induced the vast expansion of IMF's funds and a large increase in the scope of its traditional conditionality lending.

4. The Sovereign Bankruptcy (Statutory Approach) usually abbreviated to SDRM. This is the debt resolution mechanisms officially proposed by the then Deputy IMF Managing Director, Anne Krueger (2001), but – as distinct from the CACs – so far not implemented. At the general level it is meant to perform the same functions as the appropriate parts of the domestic bankruptcy laws which are applied to the firms. The essence of the bankruptcy law is that it provides a third party, a bankruptcy judge (or an equivalent institution), to which the creditors (or the debtor in distress) may legally turn¹⁰. The bankruptcy law also specifies what happens

⁹ There is a large literature on the IMF's conditionality lending. See, e.g., Lerrick and Melter (2001); Report of the International Financial Institutional Advisory Commission (2000), Dell' Ariccia et al (2002); Jeanne and Zettelmeyer (2004); Menasse and Roubini (2005)

¹⁰ To avoid misunderstanding let me add that the bankruptcy law is also a market solution, as it provides a legal mechanisms for the resolution of the market transactions

after the initiation of the bankruptcy procedure, including the scope and the mode of decision-making by the bankruptcy judge. There are important differences in the national bankruptcy laws regarding the relative rights of the creditor and the debtor, the competences of the bankruptcy judge, the details of the bankruptcy procedure, etc. (for more on this see: Corporate Restructuring...2005)

As distinct from the firms, (but similar to physical persons) sovereign states , cannot be legally liquidated¹¹. Therefore, out of the two parts of the domestic corporate bankruptcy: liquidation and reorganization, only the latter can-and does-serve as the model for the proposals for sovereign bankruptcy. The reorganization provides the basis for the restructuring of a firm in debt distress as a going concern, performed under the supervision of the bankruptcy judge. As a matter of fact, the macroeconomic adjustment and structural reforms carried out under the supervision of the IMF within the framework of its conditional lending appear to come close to this general model. In this sense the sovereign bankruptcy regime – in the functional sense as distinct from the legal particularities - already exists (see later). However, it is not what the proponents of SDRM have in mind even though – according to some proposals – the IMF would play an important role in the sovereign bankruptcy regime (see: Bolton (2003); Buckley (2009))

The best known model of reorganization under corporate bankruptcy and the most often proposed in the debate on sovereign bankruptcy is the US Chapter 11. Chapter 11 – style bankruptcy laws use four important measures (J.H. Zukin, 2005). I quote:

1. A stay, or temporary moratorium, is imposed on creditor litigation and enforcement during the restructuring negotiations.
2. Mechanisms are put in place to force responsible behavior by the debtor in order to protect creditor interest during the period for the stay.
3. New money is given priority for repayment (debtor-in-possession financing), to enable the debtor company to maintain liquidity during negotiations.
4. To prevent a small minority of holdouts from disrupting the process, relevant creditors are bound to an agreement that has been accepted by a qualified majority (a cram down)

¹¹ In the past the major power, like Britain or the US used to bully or even occupy their sovereign debtors to enforce the debt contracts. But in the modern era this type of gunboat diplomacy is gone (Reinhart and Rogoff, 2009).

The proponents of SDRM put forward various arguments in its favour, depending on what they perceive to be the main deficiencies of other debt resolution mechanisms:

1. By providing the stay the SDRM would end the creditors flight to the court house and the lengthy litigation which are typical – it is claimed – especially for pure market solutions (cf. Sachs, 2003).
2. The SDRM would solve another collective action problem: the holdout creditors disrupting the restructuring negotiations between the creditors and the debtor (Sachs, 2003, Buckley, 2009)
3. The SDRM would replace the IMF's traditional conditionality lending which is found deficient because of the bailouts of creditors and claimed policy errors (Sachs, 1995; Buckley, 2009). SDRM could deal both with country's liquidity and insolvency crises (Rogoff and Zettelmeyer, 2002)
4. Related to 3: the SDRM would ensure some burden sharing between the distressed debtor and its creditors, as it is the case in Chapter 11-style corporate bankruptcy (cf Buckley, 2009)
5. The SDRM would provide the new money so that the distress debtor could continue to function and restructure.
6. The SDRM would ensure equal treatment of the creditors belonging to the same priority class

The main problem with these arguments is that they are rarely based on a careful comparative analysis of the proposed SDRM with the other ready existing, debt resolution mechanisms. This is, in turn, due to the fact that the SDRM could have many different versions, and the detailed differences in its structural could have large practical consequences (see: Bolton and Jeanne, 2007). Comparing just the general scheme of corporate bankruptcy with the more detailed and already existing - models of alternative debt resolution mechanisms can led to wrong conclusions.

However, even in the present stage of the analysis it may be noted that at least some benefits ascribed to the SDRM can be achieved under the alternative debt resolution mechanisms:

1. Ending, the creditors flight to the courthouse (a stay). Some authors stress that it is not insurmountable problem under the pure market solutions by pointing out to the recent successful debt restructuring agreements (Velasques, 1996, Roubini, 2002, Lorrick and Meltzer, 2001, Schwartz, 2003, Paniza et al 2008). Besides, the widespread worries that the transition from bank-based sovereign debt to bond-based will magnify the collective action

problems among the creditors have not materialized (Panizza et al, 2008). Finally, the spreading CACs in the bond contracts may help to deal with this issue.

2. Eliminating the holdout creditor problem

Similar arguments apply: market-based debt restructuring suggest that pure market solutions are capable of dealing with this problem and the CACs provide an enhanced institutional basis for that (see the sources quoted above)

3. The SDRM would replace the IMF's conditionality lending. It is difficult to say ex ante whether the bankruptcy judges ordering a stay and mediating between the creditors and the sovereign debtor would be professionally better than the IMF staff negotiating the conditionality with the sovereign debtor in distress and supervising its implementation¹², which- as I have already indicated – may be regarded as a functional equivalent to SDRM.

4. The burden sharing. It is possible under the alternative debt resolution mechanisms, too. Pure market arrangements have led to deep debt reductions via the debt-buy backs or negotiations between the debtor and the creditors (Velasquez, 1996, Singh, 2003). Also the CACs provides the institutional basis for the debt restructuring or debt reduction. Finally as already mentioned, the IMF started to lend into the areas, and thus has made it possible that its proposed conditionalities may include or at least tolerate the debt relief from the creditors to the country in distress.⁵

5. The New Money. The new money during the debt negotiations can be provided under the market solutions (Velasquez, 1996). It was also the feature of the Brady Plan, an example of the modified market arrangements may also come under the CACs. Finally, the IMF lending into the areas may be regarded as a form of a new money provided by the third party to the sovereign debtor in distress.

6. Equal treatment of the creditors of the same class. It is hard to find an evidence that this is a problem which has consistently plagued the decentralized negotiations between the Sovereign debtor and its creditors. Despite the avoidability of Chapt. 11 corporate bankruptcy in the US, the overwhelming majority of the debt distress case is carried out via the out of the court work outs. If this pure market type debt resolution mechanism were burdened by the flagrantly unequal treatment of the creditors, the use of this mechanism would surely have been much more limited, and that of corporate bankruptcy – correspondingly more popular. And with

¹² According to some proposals it would be the IMF to play a role of a bankruptcy judge. This sidesteps the question of the comparative advantage of the new sovereign bankruptcy judges relative to the IMF. However it leaves the question why the new procedure would be burden by less errors than that of the IMF's conditionality lending. Other proposals suggests that the courts would play a prominent role in the SDRM.

respect to the Sovereign debt the CACs are thought to provide a sufficient bases for equal treatment.¹³

Summing up: it is hard to see, at the general level of analysis, the unique comparative advantage of the proposed sovereign bankruptcy. Other, already existing debt resolution mechanisms, can deliver the same types of outcomes which means that – at this level of analysis – they are functionally equivalent to sovereign bankruptcy. Thus points to a more general lessons for the analysis of different institutional arrangements: One should avoid being fixated by the names of the analyzed arrangements or by their legal particularities. Instead one should focus on the outcomes produced by – nominally and legally different – institutional schemes and inquire whether and to what extent they are functionally equivalent. The question to be investigated is whether the legal possibilities and incentives to the relevant actors provided by different arrangements are such that they produce similar (or different) solutions to a given problem. And this appears to be the case with the sovereign bankruptcy compared to other sovereign debt resolution mechanisms. This conclusion holds for the general level of analysis. A different conclusion might be reached if the proposed sovereign bankruptcy schemes were sufficiently specified to allow for the quantitative assessment of the different outcomes under the various options of the SDRM and the already existing (or proposed) mechanisms. I was not able to find in the relevant literature a comparative analysis of detailed SDRM schemes with the similar versions of the other arrangements for the sovereign debt resolution, so I have to stop at the general conclusion. Let me add, however, that some authors stress that the devil indeed lies in the detail and they warn against the negative and unintended consequences of badly structured SDRM (cf: Bolton and Jeanne, 2007).

So far I have been dealing with the ex post analysis of the alternative sovereign debt resolution mechanisms i.e. of how they cope with the debt distress, which is already present. However, there are some important questions belonging to the ex ante analysis of these mechanisms, and namely: how do they structure the incentives and – thus – the behavior of the sovereign debtor and its creditors before the potential debt distress crises, or – in other words – what are their relative strengths and weaknesses in contributing to the occurrence of

¹³ On a more fundamental note: Stress that there may be some value in treating certain domestic creditors, especially the domestic banks (Gelpern and Setser (2004), better than the foreign creditors.

serious debt crises (and other problems), in the first place. As I have already emphasized, this is an important criterion, as such crises are socially costly.

A debtors–friendly sovereign bankruptcy – and this is the main idea behind proposing the equivalent of Chapter 11 for the sovereign borrowers, raises two important questions. First, the very existence of such an option were bound to influence the creditors’ expectations and might thus precipitate their capital flight, i.e. a disorderly debt resolution, the very situation which the SDRM is meant to eliminate. In response to this objection one should ask whether this indeed has been a problem in the US in the case of creditors of the US debtor companies which are facing the prospect that the latter may escape to the protection of Chapter 11. I don’t know of any empirical research which would suggest a reply to this question so I have to leave it aside. However, regardless of how Chapter 11 influences the behavior of companies’ creditors, one may point out that the creditors flights are likely to have different consequences for the debtor companies relative to those which affect the sovereign debtors. In the former case it is reflected in the prices of bonds and the growing difficulties in rolling-over the debt. In the latter, there would be similar kinds of reactions, but – in addition – the fluctuations of the exchange rates (in the case of free float) or increased pressure on its official level (in the case of fixed pegs) are likely to occur. The introduction of SDRM may exacerbate this effects.

I admit, however, that one may take the view that these potential effects of the sovereign bankruptcy as beneficial for – at least - some debtor countries.

There are serious indications that the financial markets behave in a procyclical way¹⁴: lending too much during the booms and thus amplifying them and then sharply curtailing their loans, thus contributing to the bust. As a result they are poor early warning systems. In addition, because of political economy factors, government’s fiscal policy is often procyclical, too. In such a situation, a debtor-friendly SDRM would make the financial markets more vigilant in the earlier stages of lending to the sovereign borrowers and, therefore, could strengthen their early warning function, thus possibly making the governments more prudent. This, obviously, assumes that the sovereign debt crises arise mostly because of the insufficient early warnings to the governments and not due to the institutional (or personality) factors which make them ignore such warnings. In fact, there is ample evidence to the contrary, including fiscal policies in Ireland, Britain, the US, Hungary etc., before the recent crisis. Hence, to be effective, the strengthened early warnings systems would have to be

¹⁴ This tendency for procyclical behavior of financial markets may be strengthened by the procyclical monetary policy, as it appears to be the case before the present global financial crisis, especially in the case of FED

accompanied by the changes which would make the governments more sensitive to them. These changes include the institutional reforms which would constrain the growth of the public spending and/or of budget deficits and/or of the public debt. Ultimately, however, it is a strong representation of fiscally conservative voters, which is needed – in democracy – to make the governments pay more attention to signs of the incoming debt distress.

The perspective that sovereign debtors may use the debtor-friendly bankruptcy not only can make the creditors react earlier to the signals of the potential debt distress but it is also likely to induce them to charge them more for the supplied loans *vía* the increased risk premiums (see Rogoff, Zettelmeyer, 2002). This likely effect is differently assessed by various authors depending on what is regarded as the main problem for the sovereign borrowers. Those who are concerned with the costs of funds available to them, and especially to governments in the less developed economies tend to consider it as negative and, thus, they regard this effect as a weakness of SDRM. Authors who are worried by the procyclicality of the LDC's fiscal policies and the related sovereign debt crises tend to assess this effect positively and hence regard it as an argument in favour of SDRM, because they expect that increased cost of borrowed funds would make the governments borrow less, and thus reduce the frequency of serious debt crises.

My comment on this position is that it assumes that governments are price-sensitive in their borrowing activity. However at least some of them are not and then the introduction of SDRM would – in the worse case – make the sovereign borrowing more expensive without reducing the danger of the sovereign debt crises. It appears again that there are no good substitutes for measures which would make the policy frameworks and societies fiscally more conservative.

Finally let me discuss with the argument in favour of the sovereign bankruptcy which is not based on the comparison of its potential performance with that of the alternative debt resolution mechanisms but on the analogy to the evolution of the domestic corporate bankruptcy laws. This argument starts from the correct observation that laws in 19 century were very harsh for the borrowers, both individuals and firms, but were made much more balanced and debtor-friendly in 20 century, especially after the II World War. During evolution tough resistance had to be overcome (for the case of corporate bankruptcy in the US see: Bolton, 2003). It is then claimed that similar logic of progressive evolution should and – hopefully – would be present in the case of sovereign bankruptcy (eg. J. Sachs, 2003, Buckley, 2009).

However, reasoning by analogy is risky because analogies often happen to be very imperfect, and this is surely the case with the analogy I just have mentioned. In the case of individuals and firms the starting point was that in the case of insolvency they would completely lose their sovereignty as their creditors enjoyed absolute legal rights. The evolution of domestic bankruptcy law has granted the borrowers some sovereignty in the situations of the debt distress. This is understandable from the moral point of view and – up to a point – might have been economically beneficial, if the increased moral hazard on the part of the borrower has been more than compensated by their increased readiness to engage in socially useful but inherently risky innovations. However, in the case of the sovereign debtors there was never a time when their sovereignty during the debt distress could be legally eliminated, and this has been certainly the situation in the 20 century and later. Indeed, one of the main problems discussed in the literature on the sovereign debt is why the sovereigns being sovereign, i.e. not subject of the legal disciplines applied to the individuals and firms during the debt distress, are able to borrow at all (on this vast subject see, eg. Rogoff and Zettelmeyer, 2002, Panizza et al, 2008). The evolution of the domestic bankruptcy law has been from no sovereignty for the borrowers during the debt distress to some balance of rights between them and their creditors. No necessity ever existed for such an evolution for the sovereign debtors as they have enjoyed sovereignty all the time. The analogy to the evolution of corporate and personal bankruptcy law is, therefore, misleading and cannot substitute for the comparative analysis of the proposed sovereign bankruptcy law and the other already existing, mechanisms of the sovereign debt resolution.

The analysis which I have been trying to conduct above leads me to a general conclusion that there are no convincing arguments in favour of the introduction of sovereign bankruptcy. It can be shown that the existing debt resolution mechanisms are functionally equivalent to corporate bankruptcy, i.e. that they are capable of delivering the same kinds of outcomes in dealing with the sovereign debt distress. There might be some quantitative differences in these outcomes produced by the alternative ways of sovereign debt resolution. However, whether these differences are in favour of corporate bankruptcy or not is difficult to tell until this proposed mechanisms is specified in much greater detail. And some authors warn that certain specifications may lead to undesirable outcomes. In addition, the introduction of debtors-friendly sovereign bankruptcy is likely to lead to the precipitated reactions of the creditors to the signals of the sovereign debtor distress. Another likely reaction is the increased risk premium and thus, the increased cost of sovereign borrowing. For those who deplore the procyclical behavior of private lenders and the procyclical behavior

of sovereign borrowers, these reactions are the welcomed news, and constitute the arguments in favour of SDRM. However, stronger early warnings signals from the financial markets and the increased costs of borrowing in themselves, are not sufficient to contain a dangerous accumulation of the public debt. In addition, one needs a sufficient sensitivity of the sovereigns to those signals and to the increased cost of borrowing. In the worse case when such a sensitivity is lacking, the introduction of SDRM would make sovereign borrowing more expensive without reducing the danger of grave sovereign debt crises. In conclusion, while it might have been true that sovereign bankruptcy was not introduced because of the great political complications¹⁵ and due to the resistance of the private creditors (Sachs, 2003)¹⁶ it is far from certain that it deserved to have been introduced.

4. The Problem of Sovereign Debt Resolution in the EU.

Dramatic fiscal developments in Greece (and serious worsening of the fiscal stance in Spain, Britain, Ireland), have provoked a huge and ongoing debate with many proposals how to deal with the Greece's predicaments and the eurozone problems. Some of them deal with other issues than the public debt resolution. What I have in mind, first of all, are the suggestions which aim at resolving the Greece's problem of insufficient external price competitiveness – the result of years of excessive growth of consumption, both public and private. They envisage Greece temporary leaving the eurozone and then re-entering it at more competitive exchange rate (Feldstein, 2010), the temporary introduction of dual currency in Greece (Goodhart, 2010) or the radical reform which would lower the labor taxes at the expense of increasing the VAT etc. However ingenious (and controversial) these proposals are, I have to leave them aside here.

In discussing the problems of debt distress and of debt resolution with respect to the members of the EU, one has to distinguish between countries which are outside the eurozone and those that belong to it:

Some of the countries outside the eurozone: especially Britain, Hungary, the Baltics, have been undergoing a very serious worsening of their public finances. This, however, has not been widely perceived as the EU – wide problem. In contrast, the dramatic fiscal developments in Greece have been widely commented as the eurozone problem. This

¹⁵ By far the greatest complication has been necessity to have a new international treaty accepted by many countries.

¹⁶ In fact, many governments have also resisted the introduction of the SDRM for fear that it might have increased the costs of their borrowing.

difference in perception is not only due to the fact that the developments in Greece are much more spectacular than those among the countries outside the euro. A more important reason for that appears to be the danger of “contagion” in the eurozone which would erupt – it is often claimed – if Greece defaulted. There was no much mention of “contagion” with respect to the EU in the debate on the Britain’s or Hungary’s fiscal problems. It is evidently assumed that if Greece defaulted or (even the very prospect of it), the negative spillovers to other member of the eurozone *vía* the negative reactions of the financial markets, could be especially serious. However, it is not clear to me what is the basis for such a claim: Is it the very fact that countries share the same currency, or the fact that some other members of the eurozone especially the large one (Spain, Italy) are regarded by some as having a bad fiscal situation (a large budget deficit in the former/a huge public debt in the latter)? If the first factor would be the main reason, fiscal problems of Equador (dollarized) or of the Rhode Island (a small state in the US) would produce a threat to a dollar. But such an assertion is an absurd. Therefore, it is not so much the strong linkages generated by the monetary union per se, but the present composition of the eurozone: the fact that some of its large members may be perceived by the financial markets as fiscally vulnerable, that is behind the fear of contagion: If this reasoning is correct, then the solution to this problem is not only (and perhaps, not so much) the rapid fiscal consolidation in Greece but visible fiscal improvements in Spain and Italy¹⁷. This suggest that while the eurozone has the uniform fiscal rules (see later) their enforcement should be especially stringent with respect to the larger members. However, the practice has been rather the opposite.

Among the EU members outside the eurozone, Hungary and Latvia, turned to the IMF for the conditional crisis loans and obtained them. There was, to my knowledge, no much controversy about it in the EU decision-making bodies. In contrast, Greece has not – so far- used the option of the IMF assistance, and such a possibility has been subject to heated debates in these institutions (although the EU treaties do not require from a eurozone member, willing to use this option even the consultations with these institutions). It is hard to see the economic rationale for such double standards. If Hungary and Latvia were regarded to be in need for some conditional crisis lending, then this is no less true of Greece, too.¹⁸ The EU and the eurozone do not have at their disposal any ready to use institutional mechanisms

¹⁷ Such a consolidation, however, is first of all in the Greece’s interest. The lack of such an effort would matter for the eurozone if it signaled to the financial markets that the same will happen in larger countries of the eurozone (the signaling effect)

¹⁸ It is worth noting that some EU countries which facet a very serious economic and fiscal crises, Estonia, Lithuania, Ireland, are coping with its consequences *vía* tough economic adjustments and without the IMF assistance

of the crisis lending which would have the resources and the technical competence of the IMF (Pisani-Ferry and Sapir, 2010). What is more, the no-bailout clause in the EU treaties prohibits an outright crisis lending to an eurozone member (while the EU member outside the eurozone can get some assistance). There are some ingenious proposals how to go around this ban (e.g. Barber, 2010) but using them would risk provoking a storm in the countries like Germany or Netherlands. It might also contribute to the perception that the EU, while praising the importance of the rule of law, is not in fact a rule of law community, because it violates its own treaties. One must ask the question whether the opposition to Greece going to the IMF stems from the belief that no member of the eurozone should ever use the crisis lending as such or that no eurozone-member should ever use the IMF assistance.¹⁹ Both assumptions are difficult to defend on rational grounds. Therefore, one is left with the supposition that those who oppose the IMF option for Greece either err in their economic reasoning or are guided by some prestige considerations which they do not clearly spell out.

The creation of the eurozone is widely thought to be an experiment, as it is the monetary union without the political union, as distinct from – it is claimed – previous monetary unions which were combined with the political unions. This assertion is not very convincing. The countries which adopted the Gold Standard in the second half of 19 century created a monetary union – in a broader sense – without the political one. To some extent the Bretton Woods system constituted a monetary union in the sense that its fixed-peg principle sharply limited the room for independent monetary policy for the members of this system. However, they clearly did not form the political union. Therefore, instead of focusing on the “political union” as the requirement for the well-functioning monetary union, it is better to inquire what is the broader set of conditions which determine the performance of any international monetary system based on hard pegs between the member countries currencies. This is all the more true as the meaning of the term “political union” in the debate on the eurozone is often vague. My view is that in the context of the debate on the monetary union the political union should be defined as having at least two components:

1. The members of the union have limited fiscal sovereignty, i.e. there are some institutional limits on their deficits and/or debt. Within a sovereign country, which is the strongest version of political union, the regional and local governments do not have the complete freedom in this respect

¹⁹ The recent support for the idea of the European Monetary Fund in the political circles in Germany and France would suggest that it is the latter hypothesis which is true

2. There is a substantial common budget so that those parts of the political union which are hit by asymmetric shocks would get some transfers from this budget via automatic fiscal stabilizers or discretionary spending.

Condition 1 constitutes to the preventive arm of the political union, i.e. it aims at forestalling the fiscal threats to the value of the common currency²⁰. Condition 2 is the shielding arm of the political union i.e. it is designed to shield the population of the most affected regions from the deep declines in consumption. I have the impression that those who claim that “political union” is necessary (or at least desirable) for the monetary union have mostly in mind the condition 2 and disregard the condition 1, despite the fact that fiscal constraints on the local governments are clearly a typical and important component of the single sovereign states, the strongest form of the political union. In this sense they ignore the fact that Stability and Growth Pact has been in principle an important component of the political union and not its substitute (for the importance of this Pact see Tanzi, 2004)

Furthermore, the present fiscal problems in the eurozone do not result from the lack of the large common budget but from the weakness in the enforcement of the preventive arm of the political union in the eurozone. I will return to this issue in a while.

Before I do that let me add two remarks, drawing upon the experience of the monetary unions (in the broader sense), which were composed of sovereign states. First, they all required fiscal discipline from its members. This had been the case under the gold Standard with its informal norm of a balanced budget, until - both the norm and the Gold Standard – unraveled under the shocks of the First World War and then the Great Depression. Both the norm of the balanced budget and the Gold Standard were later de-legitimized among the elites because of the expansion of Keynesianism.

Second, the monetary unions which consisted of sovereign states existed without any fiscal transfers from a common center, because such a center did not exist. Instead, besides the norm of the fiscal discipline the economies of the members of the successful monetary unions of this kind displayed a great deal of flexibility, including – what is especially relevant – that of the labor markets. This was important because it facilitated and shortened the adjustments to the asymmetric shocks.

²⁰Argentina provides a warning against the political union where the regions were not constrained in their fiscal policy (see: Bestemille and Sanguinetti, 2003) However one should add that even in the US some states run into huge fiscal problems, see, e.g. California during the present recession in the US>

It is useful to look against this background at the creation and the evolution of the eurozone. To cut a long story short: Fiscal criteria (Stability and Growth Pact) were rightly introduced, as they constitute an important preventive arm of the political union important for the monetary union. In addition, at the insistence of Germany the bail-out clause was introduced in order, I think, to strengthen incentives for fiscal discipline in the respective members of the eurozone and to avoid an Argentinian-type development whereby the fiscal irresponsibility of the provinces undermined the fiscal and monetary stance of the whole union. However, from the very beginning these safeguards have been eroded by the largest countries of the eurozone (Germany, France) which obviously have had the crucial weight in the decisions regarding the creation and evolution of the eurozone. First, the original sin was committed: countries which were in violation of the fiscal criteria (Italy, Belgium, and probably Greece) were admitted into the eurozone. Second, Germany and France breached the Stability and Growth Pact. Third, in response to that, the Pact itself was modified, i.e. it was made more flexible. Many economists criticized what they perceived to be the macroeconomic imperfections of the Pact and welcomed its modifications. However, I think, they missed the essential point: rules which are violated and then quickly modified by the largest members of the club stop being the rules at all, i.e. they cease to be the binding constraints for the members of the club. I don't want to say that external pressure is sufficient to make the members respect the agreed norms of fiscal discipline. On the contrary, there is no good substitute for the domestic frameworks for the fiscal behavior of governments and what ultimately matters – for the strong representation of the fiscally conservative voters in the respective countries. However, the violation and then, modification of the agreed common norms of the fiscal conduct created a sort of the bad demonstration effect and thus made the emergence of such domestic frameworks and of the appropriate structure of the public opinion much more difficult.

The final stage in our short story is the present global financial crisis which has revealed and deepened in the eurozone the consequences of previous vulnerabilities: highly expansionary fiscal policies (especially Greece) and housing booms (Spain, Ireland).

However, just deploring the past errors is not a proper way of dealing with their consequences. What one needs instead is learning from these errors while considering what is the room for maneuver in dealing with their root causes.

It should be amply clear that there is no scope in the foreseeable future for the extension of the EU budget so as to strengthen the shielding arm of the political union via increased fiscal transfers to the members affected by deep declines in consumption. An

increased role of such a budget requires an enhanced level of group identity which can not be artificially generated by the political elites. And European Union, given the separate histories of its member states is certainly a long way from a strong European identity among the respective societies. What is more, as rightly stressed by Otmar Issing (2010) any attempt by the elites to engineer a bailout of a member which is in a clear breach of the commonly agreed rules would provoke a storm in at least some countries thus depressing – and not enhancing – the level of “European solidarity”²¹

However, this crucial point is not that an enhanced shielding arm of the eurozone is politically impossible to achieve: The key point is that it would not address the main problem: the weakness of its preventive arm and – more broadly – of mechanisms safeguarding the fiscal discipline in the respective member states.

Another pseudo-solution would consist in trying to introduce the European Sovereign bankruptcy court modeled on the US Chapter 11.²² It would have all the weaknesses of global solution of this kind which I discussed in the previous section. Besides to signal that the EU envisages the introduction of an arrangement which could entail the debt restructuring or debt reduction of its members may provoke the capital flight thus worsening and not reducing the current problems faced by some of its members.

Instead of looking at the wrong model: that of a single state, the EU institutions and countries, should focus on what are the conditions for a proper functioning of a right model, i.e. a Gold –Standard type of a monetary union, a union of countries with single currency but without any larger common budget to compensate for asymmetric shocks. While doing that one must consider, of course, some later developments which are or should be present to strengthen these conditions. The proposed analysis yields the following main conclusions:

1. The mechanisms to prevent the procyclical policies and large fiscal shocks should be strengthened as the utmost priority. This includes measures both at the level of the EU (and at the eurozone) and at the level of the respective countries:

- The accounting rules, which define the budgetary deficits and the public debt must be made credible and transparent. Enron-type accounting should have no place either with respect to companies or the governments. The rules should consider not only the explicit debt but the implicit debt, too (e.g. the pension liabilities, too).

²¹ Even within the single countries, large transfers from one part of the to another one, which are perceived to pay for the inefficiencies and waste, are likely to produce social and political tensions as shown by those between North and South Italy and, perhaps, by West and East Germany

- The monitoring of the budget deficits and of the public debt must be strengthened. This is the job for the Eurostat, the European Commission and for the European Risk Council, proposed by de Larosiere report (2009). The monitoring should also focus on the development of the asset bubbles which, when burst, may produce deep recessions and the resulting sharp increases in the budgetary deficits.
- Stability and Growth Pact should be enforced which implies the use of the available sanctions. They should be strengthened, if possible.
- The monetary policy of the ECB should pay more attention to the developments of asset bubbles, i.e. should “lean against the wind”. In other words it should be more conservative than the policy which is only guided by the inflation measured only by the CPI. It could mean that the ECB makes more use of its monetary pillar in its decisions on the interest rates.²³
- The ECB’s common monetary policy cannot fit the macroeconomic conditions of all the member countries. For example, the ECB’s interest rates were too low for Spain or Ireland which contributed to the developments of asset bubbles in these economies with the resulting bust, the recession and the large increase in their public debt. Therefore, the eurozone countries (and other countries, too) need an additional instrument: the macroprudential regulations which aim at reducing the excessive growth of credit. While the need for such regulation is nowadays widely recognized, much technical work remains to be done.
- The initiatives at the EU and/or at the eurozone level cannot substitute for the strengthening of the preventive mechanisms in the respective countries, which is ultimately the responsibility of the domestic politicians and the public at large. However, the disciplining measures at the EU level are desirable or, perhaps, even necessary to spur the growth of the preventive mechanisms in the respective countries. And the EU initiatives are largely dependent on large countries, Germany, France, Italy, Spain bear a special responsibility for the developments in the eurozone – and in the EU.

2. The EU and especially the eurozone countries, must accelerate the structural reforms which would, first, strengthen their long-run growth and, second, smooth the adjustment to shocks, including the fiscal ones. The former is not only necessary for the continued improvement in the standard of living of the populations but also to help them to grow out of the increased public debt (cf: White, 2010). The latter would make the results of various shocks less painful, especially with respect to unemployment. There is a long list of necessary measures

²³ The best solution would be that the FED, another globally important central bank changes its approach, too. Otherwise, a more conservative ECB’s policy would lead to the appreciation of euro.

both at the level of the EU and that of the respective countries. Let me mention the steps which I consider to be especially relevant:

- At the EU level, probably the most important mechanisms for longer term growth of all the member states is the Single Market. Therefore, economic nationalism which risks damaging it must be prevented at all costs. This is necessary but not sufficient. The vigorous effort to complete the Single Market should be launched. This applies, first of all, to non-financial services, where there is the largest gap *vis a vis* the US.

- The Lisbon agenda should focus on the economic goals and be reinvigorated. This should mean more market reforms and not setting the numerical measures, which make little sense, e.g. requiring that all countries spend 3% of their GDP on RandD.²⁴

- The EU institutions and countries should urgently reconsider measures which risk imposing additional burdens on the economies and/or hamper the flexibility of markets. I have in mind first of all, the EU's climate policy which has had a weak analytical basis and has been presented as though it was offering a free lunch. The drift toward the social policy increasingly becoming the EU's responsibility should be stopped, as it risks introducing additional rigidities and burdens in the more flexible economies and rises the fundamental constitutional questions (the subsidiarity principles)²⁵

- The fiscal reforms in the respective EU countries are not only fundamentally important for the short-run, i.e. to deal with the increased budgetary deficits and the public debts, but from the longer run, too. Persistent deficits and a large public debt are detrimental to the longer-term growth, because – sooner or later – they crowd out private investment and introduce harmful uncertainty, which worsens the investment climate. The mode of fiscal consolidation also affects the forces of growth: As all of EU members have already large tax burden, further tax increases would weaken those forces. The focus of fiscal reform should, thus, be put on measures which reduce the growth of spending commitments, which –given the aging of the EU societies – must include the pension reforms that raise the age of retirement.

- Rigid (or dual) labor markets and – more generally - and rigid prices, and regulatory constraints on the supply response of the economy, deepen its recessionary reaction to various shocks, and contribute the growth of unemployment. Therefore, the liberalizing reforms should be a priority wherever needed, and should be the another focus of the reinvigorated Lisbon Agenda.

²⁴ This target disregard the differences in the level of development: economies with larger per capita income can use more technology transfer and thus need to spend less on RandD. Besides the increased RandD should result from the reforms which increase the slope of markets and the intensity of competition.

²⁵ For more on that see: S. Klecha (2008), M. Threlfall (2007)

No amount of exclamations about the “European Solidarity”, “social cohesion” and “European Social Model” can substitute for these reforms, especially – as I already stressed – the EU-wide shielding fiscal policy is not in prospect and – even if it were – it would not provide the proper response to the main problem: the weakness of the preventive mechanisms in the EU.

I must finish in looking at the proposal of the European Monetary Fund (EMF) put forward by D.Gross and T. Meier (2010) and supported – as the general idea – by some EU officials and some politicians in the EU countries.

The authors stress that the IMF has technical expertise and fewer political constraints than the present EU institutions (the EU Commission) but “is helpless in the face of a determined offender, as the case of Argentina in 2001.” The same might true of the European Commission, although they acknowledge that its capacity to devise a tough adjustment programme “depends in the final analysis on the stance taken by Germany, the member state, whose financing power would be indispensable”. They emphasize that the EU already has several instruments at its disposal to deal with a fiscally irresponsible and recalcitrant member of the Eurozone, say, Greece: it can withhold funding from the structural (and other) funds, and the ECB “can exert enormous pressure by disqualifying Greek public bonds for use under its monetary policy”. Nevertheless they propose the EMF, in order as they stress – to strengthen the enforcement (prevention) mechanisms in the eurozone:

1. The member countries that breach in Maastricht Criteria would pay compulsory contributions proportional to the size of the breach, i.e. the deficit exceeding 3% of the GDP and the public debt in excess of 60% of GDP. This is meant to strengthen incentives for prudent fiscal policy.
2. These contributions would finance the conditional lending to the countries facing crisis. In addition, the EMF would borrow – similar to the IMF – on the international markets to augment its resources.
3. Any country could call on the funds of the EMF up to the amount it has deposited in the past, provided its fiscal adjustment programme has been approved by the Eurogroup. Any drawing on the guarantee of the EMF above this amount would be possible only if the country agrees to a “tailor –made programme supervised jointly by the Commission and the Eurogroup”.
4. The creditors of the eurozone country which would be in threat of default or would threaten the default itself would be offered by the EMF the exchange bonds with the appropriate

haircut (reduction in value). This is meant to provide for “orderly default” and thus risk the contagion affecting other members in the eurozone.

5. By acquiring the debts of the eurozone country the EMF would acquire special powers with respect to this country: From that time onwards, any additional funds the country would receive could be used only for specific purposes approved by the EMF other EU transfer payments would also be distributed under the EMF scrutiny or they could be sued to pay down the debt owned by the defaulting country to the EMF.

The Gross- Mayer’s proposal, however, ingenious, raises a host of questions:

- Its main merit, according to the authors, consists in the sanctions against countries breaching the Maastricht criteria. However, the same effect could, in principle, be achieved by the graduated use of the existing disciplinary mechanisms in the EU and the eurozone, without going through a lengthy and politically difficult process of setting up the EMF. If there were no political will of using these mechanisms why should one expect enough political will to agree to the creation of the EMF in a suitably hard version?
- The focus on creating the EMF might divert the attention from using the already available sanctioning mechanisms.
- The exchange offers, proposed to be the main mechanisms to be applied by the EMF to reduce the debt burden of the debtor country, are one of the already available market ways of dealing with the debt distress (see section 4). Should the eurozone country be prohibited from using this method, and – if yes – why? The response that a more “orderly” default could be reached than otherwise. However, why it should be more orderly than under the IMF lending into areas, linked to an adjustment programme?
- An “orderly” default is probably meant to be the one which limits the contagion to the other eurozone countries. However, this does not depend on setting up a new institution but on the fiscal vulnerabilities of the larger members, which depend, in turn, on the use of already existing disciplinary mechanisms and on their domestic institutional and political developments.
- If the EMF were created and the eurozone members were prohibited from using the IMF the global role of IMF would be undermined. As R. Henning (2010) has noted: “Rather than a system of mixed crisis finance – where multilateral funds are mixed up with regional and bilateral assistance – we would have a regionally balkanized system in which IMF is displaced to everyone’s detriment.”

Summing up: the Gross- Mayer proposal raises some fundamental questions. Besides, if it is taken up in the EU political process, it is likely to use the scarce political capital, which is necessary to start using the available mechanisms now. Finally it is not the substitute for a broader set of measures which I have outlined earlier.²⁶

6. Concluding Comments

Debt distress situations are usually divided into the illiquidity and insolvency. However useful is this distinction, it is not easy to make ex ante, especially in the case of sovereign debtors. Another distinction which is difficult to make is between their incapacity and unwillingness to pay. From a purely economic point of view there exist almost always an economic programme that, if implemented, would make the debtor country capable of paying back their debts. The true questions are, therefore, whether the implementation of such a programme is, first, desirable, and , second, possible from the socio-political point of view. In tackling the second issue one should avoid falling into a trap of granting countries with more populist socio-political structure a more lenient treatment than granted to those which are more disciplined.

A deeper analysis of a sovereign (un)willingness to pay must consider its political regime and the composition of the public debt, especially along the resident-non-resident dimension.

Based on the existing literature, I have distinguished four alternative sovereign debt resolution mechanisms: pure market solutions, modified market solutions, the assistance from the IMF, the Sovereign Bankruptcy (SDRM). The proponents of the SDRM often claim that it would produce some unique benefits. However, the comparative analysis I have carried out in the section 4 does not validate this assertion. It shows that the same kinds of outcomes may be achieved under alternative debt resolution mechanisms which – as distinct from the SDRM – already exists. At least some of them may be considered to be functionally equivalent to the SDRM. This suggests that in analyzing alternative institutional structures one should avoid being fixated by their names and by their legal particularities. Instead one should focus on the options and the incentives they produce with respect to the relevant actors.

The SDRM may also change the behavior of sovereign debtors and their creditors thus rising some important questions of ex ante analysis. They can/induce the financial markets to be more vigilant and to charge more for risks related to the potential use of the SDRM by the

²⁶ To be fair to the authors: they certainly did not mean the EMF to eliminate the need for fiscal and structural reform in the EU member states.

sovereign borrowers. Those who are worried about the volatility of these markets and the cost of borrowing by poorer countries, would deplore these potential effects and consider them as an argument against the SDRM. Authors who are worried by the procyclicality of these countries' fiscal policies tend to welcome these effects and, hence, consider them as an argument in favour of the SDRM. However, more vigilant and risk-aware financial markets are not enough to discipline the undisciplined sovereign borrowers. In addition, they need institutional reforms which would make them more sensitive to the warning signals of the incoming debt distress. Ultimately, what they need is a strong representation of fiscally conservative voters (if they have democracy).

Turning to the EU it is hard to understand on economic grounds why there was no much discussion in the EU before Hungary and Latvia which do not belong to the eurozone, turned to the IMF for conditional assistance, while there has been huge resistance against Greece doing the same.

The creation of the eurozone is often regarded as an experiment because – the story goes – it meant the creation of the monetary union without the political one. However the proponents of this view seem to equate the political union with the model of a single sovereign state and especially deplore the lack of large fiscal compensatory mechanisms in the present eurozone. However, I suggest that they use the wrong model. First, they disregarded the importance of fiscal constraints imposed upon the local and regional governments in the single states. In this sense, the Stability and Growth Pact has been, in principle, an important preventive part of the “political union” and not the substitute for such a union. Second, the present fiscal problems in the eurozone are due to the erosion of the fiscal discipline in the eurozone, partly, due to the disregard and, then, modification of the Stability and Growth Pact – and not to the lack of a strong compensatory transfers within the eurozone. Third, the right model to look at conditions for the stability of the eurozone is not a single State but the Gold Standard system, a system of sovereign states with (de facto) single currency. Based on this analogy and considering modern developments I list the conditions which are considered essential for the stability of the eurozone. I divide them into two groups: first, measures which would reduce the procyclicality of the macroeconomic policies and of the economy; second – reforms which would help the eurozone economies to grow out of the increased public debt and to deal with the future shocks in a better way. All of these reforms are, of course, also needed in the EU countries which do not belong to the eurozone.

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