Euro Pathologies

Although some of the pathologies related to overborrowing and delayed restructuring that were described in chapter 2 can be illustrated using euro area experiences (particularly the case of Greece), they have been well known in emerging market settings for some time. This said, the euro area does appear to be special in ways implying that the general case for an overhaul of the rules governing debt restructuring—and particularly for a treaty-based mechanism—may apply with special force. In particular, the euro area embodies two structural features that exacerbate both the ex-ante pathologies described in chapter 2 and the difficulties of managing debt crises ex post, particularly in combination.

First, a debt crisis afflicting one country in the euro area constitutes a common problem for the entire currency area, to a degree that dwarfs crisis-related spillovers anywhere else in the world. This is partly the result of close trade and financial linkages—including through holdings of sovereign debt by banking groups and other institutional investors with cross-border presence. However, economic linkages are also very high—for example, between the U.S. and Canada, between the U.K. and some euro area countries, and between Germany and Switzerland—without tying these countries together in quite the same way as within the euro area. Apart from a shared and often difficult history that rarely leaves room for indifference, what sets the euro area apart from other highly integrated areas is that the common currency itself constitutes a powerful channel that links economic outcomes among its members. This is partly because the policies of the European Central Bank (ECB) affect the entire currency area, but most of all because of the threat of a collapse of the common currency, and the associated disruptions that this would create across the currency area. As a result, a disorderly default in one part of the currency union could have massive implications for its other members—even members whose direct exposures to the afflicted country are not very high.

Second, euro area countries have fewer policy instruments for dealing with high debt. In particular, unless the euro area as a whole has a debt problem that is symmetrical across most members of the currency union, the area’s member countries cannot count on devaluation or accommodative monetary policy to offset the contractionary impact of fiscal adjustment. As a result, debt reduction efforts are economically and socially more costly for given debt and deficit levels, and debt sustainability problems arise at lower levels of debt than in comparable countries with their own monetary authorities.
Note that the second problem—a lack of monetary policy instruments to help deal with high debt—is by no means unique to the euro area. It is, in fact, almost identical to the standard problem arising from foreign currency borrowing that has afflicted emerging market economies for many decades. Just as in the euro area, the presence of foreign currency debt renders standard monetary policy instruments essentially useless in a crisis, and implies that crises can be self-fulfilling.23 What is special about the euro area, however, is the combination of a lack of instruments to deal with debt crises in individual countries and the fact that, if these debt crises spin out of control, there could be dire consequences for the entire common currency area. As a result, the need both for a regime that prevents the emergence of debt problems and for additional policy instruments to handle debt crises when they do occur has been much more urgent in the euro area than elsewhere.

So far, these “additional policy instruments” have consisted mainly in the combination of fiscal adjustment and large-scale, conditional official support (either through the European Financial Stability Facility / ESM or the ECB’s “Outright Monetary Transactions” program). Though these forms of support can stop self-fulfilling debt crises when debt is in principle sustainable, by definition they do not work in unsustainable debt cases. But because official support and fiscal adjustment are the only instruments on the table, the existing regime creates an incentive to misdiagnose debt problems—declaring the unsustainable sustainable—and to stigmatize those that disagree. Before the Greek debt restructuring finally became the official policy of the European Union in the second half of 2011, even the discussion of debt restructuring in Europe was effectively branded as un-European by influential policymakers.24 In turn, this can result in adjustment burdens that ultimately prove unfeasible, but usually not until they have caused great social and political harm.

At the same time, large-scale crisis lending can give rise to moral hazard, at two levels: at the expense of the European taxpayer if official loans themselves have to be written down—as seems likely when lending occurs in unsustainable debt cases—but also at the expense of the domestic taxpayer, who is required to repay official loans that are being used to service debts to private creditors. The consequences are underpricing of debt and overborrowing, particularly in countries with weaker institutions and political systems that are not fully responsive to taxpayer interests.

Fortunately, the euro area is special not only with respect to its problems in preventing and containing debt crises but also in its potential to establish common institutions or legal frameworks to create new solutions. Euro area members are of course also members of the EU, which has had a long, and for the most part successful, record of cooperating through supranational legal frameworks and institutions. Furthermore, the euro area has one particular specific institution—the ESM, created by treaty in 2012—that could be easily adapted to embed a treaty-based debt restructuring regime. The next chapter hence explores the possibility of an amendment of the ESM treaty that would attempt to impart incentives for better debt management ex ante, bestow legitimacy on debt restructuring when this is in the common interest, and deal with the legal obstacles to debt restructurings posed by holdouts.

Before going down this route, however, it is necessary to address four possible objections, all of which are specific to the euro area context:

- First, does the diagnosis change if one takes into account the nexus between public and private debt—including overdrawing by banks? In light of this nexus, might the creation of a euro area–based Banking

---

23 See Jeanne and Zettelmeyer (2003), and the references therein.
Union—with a common fiscal backstop—be sufficient to deal with sovereign debt problems in Europe?

- Second, was the Greek debt restructuring a game-changer in the sense that it demonstrated the feasibility of orderly debt restructuring in the euro area? In light of this success, does the euro area still need a more formal restructuring regime? Or does the Greek restructuring solve the problem both ex ante, by sending a warning to future reckless sovereign borrowers and lenders, and ex post, by creating a template for future restructurings in the euro area, should they become necessary?

- Third, could the problem be solved by the “aggregated” collective action clauses that, since early 2013, have begun to be incorporated into the newly issued sovereign bonds of all euro area members? Do these CACs already constitute a restructuring regime of sorts that might obviate the need for a more heavy-handed alternative?

- Fourth and finally, could the recent reforms of the European fiscal framework make a debt restructuring regime redundant? Should not the new rules and strengthened oversight suffice to ensure fiscal discipline and to curb moral hazard? Also, ESM funding is already conditional on fulfilling the fiscal targets, so why is there a need to go any further?

Banking Union and the Nexus between Private and Public Debt

It has often been pointed out that the euro area crisis was primarily caused by capital flows and bank credit directed mainly at private rather than public borrowers, together with the higher risk premia and break-down in interbank lending triggered by the subprime crisis in the United States.\(^{25}\) With few exceptions—chiefly, the problems of Greece—sovereign debt problems in the euro area have been a consequence, rather than the cause, of this broader crisis.

In the context of the discussion so far, this raises several questions. If the main problem in Europe was (and to some extent still is) privately held debt, does the emphasis on sovereign debt restructuring miss the point? Even worse, might a sovereign debt restructuring regime be rendered ineffectual by the tight link between private and public debt? And to the extent that this link is at the core of the sovereign debt problem in Europe, would it not be addressed by the Banking Union that Europe has begun to build, obviating the need for a sovereign restructuring regime?

The first and most obvious answer to these points is that although public and private debt are related for the usual reasons—because private overborrowing can become public in a banking crisis, and but also because public overborrowing can crowd out private borrowing—they are still separate problems in the sense that they are driven by distinct moral hazard problems, each of which would continue to pose a threat if the other were eliminated. In particular, even if new financial sector institutions and macroprudential policies were to eliminate any chance of unsalutary private credit booms in Europe, a potential public overborrowing problem would remain, for the reasons described in chapter 2, and would be particularly important to address in the euro area. For the reasons described earlier in this chapter—the lack of country-level monetary policy instruments, larger mutual costs of debt crises, and moral hazard—prudent sovereign debt levels in a currency union of closely integrated economies should probably be lower than elsewhere. This may require a supranational debt restructuring framework to both set

---

\(^{25}\) See, e.g., Lane (2012); Lane and Pels (2012); Shambaugh (2012); Sinn and Wollmershäuser (2012); and Hughes Hallett and Martínez Oliva (2013).
the right incentives and deal with large accidents. The presence of such a framework does not, of course, obviate the need to also improve financial sector supervision and resolution, both because of the disruptiveness of crises caused by private credit booms and to prevent private debt from becoming a public liability.

Second, while sovereign bankruptcy should obviously not be the first line of defense against banking crises, it can help, even with private borrowing problems. Ex post, it would provide a framework for the restructuring of public liabilities regardless of their origin. To the extent that debt markets believe that private liabilities could at some point become public, this should create additional incentives—via the national treasury—to prevent overborrowing. In a country with rapidly rising private debt and a strong chance that this debt will become public, but without any chance of sovereign debt restructuring, sovereign borrowing will remain cheap. In the same world with a chance of debt restructuring, unsustainable private borrowing should at some point begin to affect sovereign risk premia, even if sovereign debt remains low. Because it gives the fiscal authorities a wake-up call, this is a good thing.

Third, euro area-based Banking Union, a fiscal backstop and a sovereign debt restructuring regime should be viewed as—indeed, a sovereign debt restructuring regime is likely necessary for the proper function of the Banking Union. Based on the arguments that were made at the beginning of this chapter, one can in principle imagine two alternative, internally consistent institutional arrangements for the euro area that recognize the links between public and private debt. First, one in which both supervision and resolution remain national responsibilities, and in which a sovereign debt restructuring regime deals with national debt shocks—regardless of whether their origin lies in the public or private sector. Second, one in which both supervision and resolution are joint, and there is both a common backstop and a sovereign debt restructuring regime.

In a financial area with cross-border banking, the latter is preferable because it internalizes the multicountry effects both of banking in normal times and of bank resolutions. But it will work only if the authorities whose decisions ultimately influence the quality of bank assets have the right incentives. With major decision areas—for example, influencing housing markets—remaining at the national level even in a perfect Banking Union, this requires that national authorities retain “skin in the game,” in the sense that national fiscal backstops, if required in the resolution process, are tapped before common euro area–level backstops. This, in turn, requires that meaningful fiscal buffers exist at the level of all euro area countries, which in turn require creating incentives against overborrowing through standard fiscal channels—one of the purposes of orderly sovereign restructuring. At the same time, because significant decisionmaking authority in the Banking Union will be centralized, the possibility of sovereign restructuring does not obviate the need for a common fiscal backstop. If decisionmaking authority over national financial systems is explicitly or implicitly shared, so, too, must fiscal responsibility.

The Greek Debt Restructuring—a Template?

Notwithstanding its restructuring-unfriendly conditions, the euro area recently pulled off the largest debt restructuring in history: the 2012 Greek bond exchange, which was successful in the sense
of being orderly; in achieving high creditor participation (97 percent); and in resulting in large debt relief, on the order of 50 percent of GDP. Was the Greek restructuring a game-changer that it could by itself usher in an era when unsustainable debt cases in Europe are dealt with through orderly restructuring? Even ignoring the fact that European policymakers have consistently emphasized that the Greek case would remain unique and not set any precedent for the handling of other high-debt cases, there are reasons to doubt this.

First, the Greek debt restructuring was quick and achieved high creditor participation for mainly one reason: 93 percent of Greek bonds were governed by local (Greek) law. This permitted the Greek Parliament to “retrofit” a collective action mechanism on the local law debt stock that operated to sweep potential holdouts into the deal, and also gave Greece scope to offer creditors extra incentives that reduced the appeal of holding out, namely, an upgrade in governing law. However, not every euro area country enjoys the local law advantage that Greece did. This applies particularly to some of the smaller euro area countries and borrowings by subsovereign entities. Cyprus is a case in point. During its recent bail-in of investors, it imposed the bulk of the pain on its bank depositors, while holders of its foreign-law-governed bonds (a substantial portion of its debt stock) have been paid in full and on time.

Second, the Greek approach to restructuring required large volumes of official financing, as the exchange offer included an exceptionally high “cash sweetener” to incentivize participation. This is unlikely to be repeated. Rescue money is becoming scarce in the euro area, both because of public and political opposition to further bailouts and because the pool of available resources is shrinking, as demand continues to increase and the potential roles of the European Financial Stability Facility / ESM are being expanded (most recently to direct recapitalization of banks).

Third, the Greek restructuring gave potential holdouts an easy pass—both by avoiding virtually any threats directed at holdouts ex ante and by repaying them in full ex post. This creates a precedent that will likely embolden holdouts in future restructurings.

Fourth, a little-noticed aspect of the Greek restructuring is that it attempted to restructure not only its sovereign bonds but also some of its sovereign guarantees. Sovereign guarantees can quickly become direct sovereign obligations when a country hits a crisis (particularly if the guarantees were being used to prop up already-weak domestic institutions that become weaker still when the crisis hits). As a historical matter, sovereign guarantees have tended not to pose a major problem in restructurings because distressed nations do not usually have too many of them. The crisis in the euro area, however, has been different. Many of its members have issued large volumes of sovereign guarantees in the period since 2008, and are continuing to do so. This means that when the next euro area restructuring comes along, the guarantees will also need to be tackled, without a clear playbook on how to do so (Buchheit and Gulati 2013).

Finally, a large fraction of the bonds issued by the weaker euro area sovereigns have recently been moving out of the hands of foreign investors and into the hands of local banks and other domestic institutions (Brutti and Sauré 2013). That means that any significant restructuring of the govern-

27 This is not to say that it was perfect. It came far too late, created large risks for the European official creditors, left money on the table, and ultimately was not deep enough to restore Greece to sustainability. Furthermore, it created a bad precedent in its exceedingly generous treatment of holdouts. For the details, see Zettelmeyer et al. (2012).

28 Quasi-cash payouts (in the form of short-term European Financial Stability Facility bills) made up about two-thirds of the value of the package of new instruments offered to Greece’s private creditors. This high reliance on cash seems to have been unprecedented in the history of sovereign debt restructuring. See Zettelmeyer et al. (2012) for details.
ment’s debt may cause a domestic banking crisis. Of course, this is the reason why the migration of sovereign debt to domestic holders, and banks in particular, could be happening. Domestic banks are relatively immune from restructurings because they expect to be recapitalized, for financial stability reasons, if their losses from domestic sovereign bond holdings are sufficiently high. Indeed, if the holdings of the banking system as a whole are high enough, the restructuring will likely not happen at all (see Broner et al. 2010).

Hence, while the Greek debt restructuring approach was successful in Greece and can be useful in specific cases, it falls short of providing a template that could be a permanent fixture of the European financial architecture. Indeed, its success was partly due to strategies—including the large-scale use of cash incentives, and the generous treatment of holdouts—that may make future restructurings more difficult.

Are the New Euro-CACs the Solution?

Since January 2013, newly issued European sovereign bonds have begun to incorporate collective action clauses. The trigger for a debt restructuring (both sovereign, as in the case of Greece, and private, as in Cyprus) is based on an ex-post debt sustainability assessment by the Troika i.e., the European Commission, the ECB and the IMF). The intention of these clauses is to facilitate debt restructuring when appropriate and improve incentives ex ante. But unfortunately, the new regime is unlikely to be sufficient, for two main reasons:

- Although euro-CACs may help with the ex-post debt restructuring, they are no panacea, as they need to be voted on bond by bond (see Gelpern and Gulati 2013).

It is telling that distressed debt investors explicitly targeted Greek bonds with U.K.-law CACs: These holdout investors succeeded by purchasing blocking minorities in individual bond series, which could not be offset by pro-restructuring majorities elsewhere. Though euro area CACs contain an “aggregation feature” that allows changes at the individual bond level to be decided with a lower majority if enough investors across all bonds vote for a restructuring, this feature is much weaker than the mechanism for aggregating bondholder votes across all domestic law bonds that was used in Greece.29 Furthermore, euro-CACs do not deal with the vast existing stock of European sovereign debt. Some of this was issued under domestic law so that CACs can be “retrofitted” if necessary, but a significant amount of it is not.

- Case-by-case sustainability analyses are part of the negotiation, and not predictable. As such, they do not help with the ex-ante distortions, particularly when declaring a country insolvent remains an unattractive option in light of the restructuring barriers that remain even with euro-CACs.

A possible solution might be to reform the newly introduced euro-CACs in a way that they allow aggregation across bond series, without bond-by-bond voting. However, even if this happened, it will take another 5 to 10 years until they will be contained in the majority of euro area sovereign bonds. Until then, there will be a mixed regime of pre-2013 bonds (mostly without CACs) and post-2013 bonds (with euro-CACs). And even in 10 years, it is not clear whether euro-CACs would ever be used, as the decision to withhold ESM support and encourage countries to restructure remains

---

29 The aggregate voting threshold is higher than in the Greek “retrofit” CAC (75 rather than 66.67 percent). Furthermore, euro-CACs require at least a 66.67 percent vote in each individual bond issuance, while in Greece it was sufficient to reach this threshold in aggregate.
discretionary, and may or may not be optimal ex post. This is far from the regime that Europe needs to both succeed in future restructurings and create good incentives ex ante.

**Is a Debt Restructuring Regime Redundant?**

After the obvious failure of the fiscal (and macroeconomic) framework, the EU and the euro area embarked on a large-scale effort to strengthen its governance. In particular, the so-called six-pack (i.e., six regulations designed to strengthen fiscal discipline and macroeconomic surveillance) was adopted by all EU member states in 2011; an intergovernmental treaty (Treaty on Stability, Coordination, and Governance), also called the “fiscal compact,” was signed by 25 EU member states in 2012; and two further regulations (the “two-pack”) entered into force in the countries of the euro area in 2013.30

Together, these new regulations have substantially changed the governance of the euro area. On the fiscal side, for instance, excessive deficit procedures may now be launched on the basis of a debt ratio above 60 percent of GDP that does not diminish sufficiently rapidly. The debt reduction path must follow a numerical benchmark, and progressive financial sanctions kick in at earlier stages than previously. The fiscal compact further reinforces fiscal targets, mandates their implementation in national law—preferably at the constitutional level—and gives the European Court of Justice the right to monitor the implementation of the law and impose sanction for noncompliance. Furthermore, the ESM is barred from lending to countries that violate the fiscal compact, giving countries a further incentive to keep their fiscal house in order; by the same token, the presence of the ESM should not cause incentives to engage in fiscal profligacy.

Finally, the two-pack introduces EU-level budget monitoring and coordination through a common budgetary time line and procedures. For the euro area countries, the commission will now examine and give an opinion on the draft budget, and may ask for the submission of a revised plan.

With all these new instruments and powers, one could conclude that the euro area is already sufficiently equipped to ensure fiscal discipline and prevent repeated debt crisis. However, this conclusion would be premature, for two reasons.

First, although the fiscal compact mandates fiscal rectitude and prohibits the ESM from helping countries that do not comply (after an adjustment period, agreed on country by country), it does not provide any alternative instruments for dealing with a debt crisis. This means that if a country does not follow the rules and a crisis does arise, European policymakers will again be caught between a rock and a hard place. If they reject a country’s call for support, they will likely force it into a debt restructuring, but without tools that legitimize the restructuring and ensure its orderliness. This may again lead to pressures to make an exception and allow the ESM to lend to the country after all—very similar to the pressures that led the IMF, for example, to change its exceptional access criteria in order to enable it to lend to Greece.

Second, the most of the new rules aim at improving discipline in fiscal terms. Although the six-pack also introduces a new macroeconomic imbalance procedure, which together with the European Systemic Risk Board is to monitor and prevent excessive risk taking in the financial and in the private sector. However, this may not be sufficient to rule out situations where a country’s debt becomes unsustainable because of the accumulation or “discovery” of quasi-fiscal liabilities which become fiscal in a crisis.

---

Building a debt restructuring framework for Europe on top of its existing fiscal governance would at worst be costless and at best essential. If the new rules do indeed ensure that the debt of all euro area members declines to below 60 percent of GDP and remains there, the restructuring regime would serve as a second line of defense that may never be breached. The probability of a debt restructuring in such a case would be minimal, and so would be any impact of a debt restructuring regime on borrowing costs. If, conversely, the new rules do not work as intended—as may be the case if euro area countries are not able or willing to live up to their new commitments, or if their debts become unsustainable for reasons outside the new fiscal rules—a debt restructuring regime would harness market discipline in normal times and provide a safety valve in crisis times.