

Sovereign debt restructuring Main drivers and mechanism

SUMMARY

This briefing provides an overview of the main issues relating to the restructuring of sovereign debt, and outlines the factors which impact the decision as to whether or not to proceed with debt restructuring. Restructuring is a complex issue – it involves positive and negative aspects, which need to be analysed in order to be able to determine whether it can deliver any added value.

‘A sovereign debt restructuring can be defined as an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a legal process’.¹ The current situation in the euro area, characterised by high levels of debt and the continuing trend of many Member States to run budget deficits, combined with a low growth environment, raises the issue of debt sustainability. In addition, the low level of inflation recorded in recent years (and deflation in some cases) has played an important role in the increase of debt burdens.

The lack of an EU - level transparent framework for sovereign debt restructuring could potentially entail higher additional costs. As part of the EU’s financial stability management instruments, sovereign debt restructuring could form a part of the EU toolbox.



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Introduction

According to the International Monetary Fund (IMF), past experiences demonstrate that 'debt restructurings have often been too little and too late, thus failing to re-establish debt sustainability and market access in a durable way'. To date, no EU-level legislation covers sovereign default or sovereign debt restructuring. Consequently, should any EU Member State face a problem with unsustainable sovereign debt stock, each situation is solved on ad hoc basis. The lack of a transparent EU framework could entail additional costs

The 2008 financial and economic crises led to a substantial contraction of EU Gross Domestic Product (GDP); euro area GDP only returned to its pre-crisis level in 2016, representing billions of euros of lost wealth generation and accumulation. However the crisis is not yet over, in recent years, sovereign debt levels have increased significantly. Some countries have used budgetary resources to support a failing banking sector and increased budgetary spending on infrastructure projects, whilst facing a decrease in tax income as well as an increase in statutory and non-statutory social expenditure (automatic stabilisers). Five out of 19 euro area countries have a debt-to-GDP ratio exceeding 100 %, and only five are below 60 % (stability and growth pact criteria). In contrast, in 1995 only two countries exceeded the 100 % threshold, with 12 countries below 60 %.

Several fiscal consolidation measures were implemented to restore these countries' public finances: taxes were increased and public expenditure cut. All these measures should, according to the economic literature, result in depressed domestic demand; which is indeed the case in many European countries. While the effects of structural and fiscal consolidation measures generate benefits after a certain time lag, from a short term perspective, consolidation could amplify the negative cycle. Fiscal consolidation could also lead to increased short term political risk.

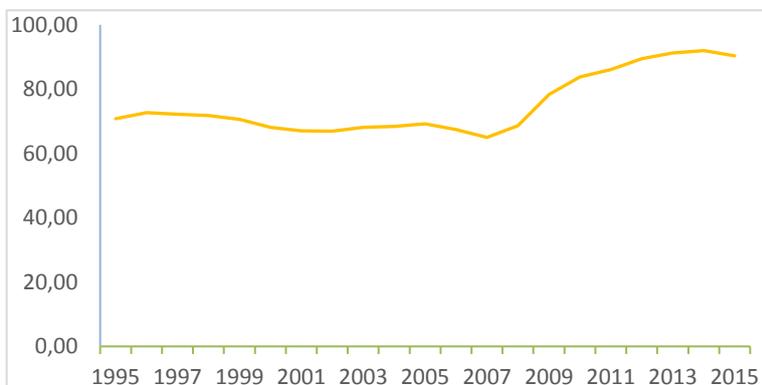
The absolute or relative level of debt is not, as such, a direct source of concern; what matters more is the speed at which the debt increases. Increased levels of public debt create fears of debt sustainability problems in some countries – a situation generally defined as where a country's growth rate is lower than its real interest rate, and which might ultimately lead to payment default. In such a situation, the sovereign debt is perceived as riskier, implying an increase in the interest rate the country pays to finance itself. In turn, higher interest rates produce higher debt servicing costs, resulting in a negative spiral.

The EU has put in place new tools to better manage financial and economic stress and to avoid situations in which a local problem becomes systemic, putting the proper functioning of the economic and monetary union at risk (e.g. [European Stability Mechanism](#), [Single Supervisory Mechanism](#), [economic governance – six pack](#), [two pack](#), [European semester](#), [Banking Union](#)). As the structure is not yet complete, it is not at an optimum level to tackle and reduce risks (see [Testing the resilience of Banking Union: Cost of Non-Europe Report](#)). Some elements are missing, e.g. a European deposit insurance scheme and a mechanism to restructure sovereign debt within the euro area. Completing the EU's toolbox would have a significant potential added value in case of renewed stress or shocks.

Debt situation

Currently, gross government debt as a percentage of GDP is at its highest historical level (Figure 1).

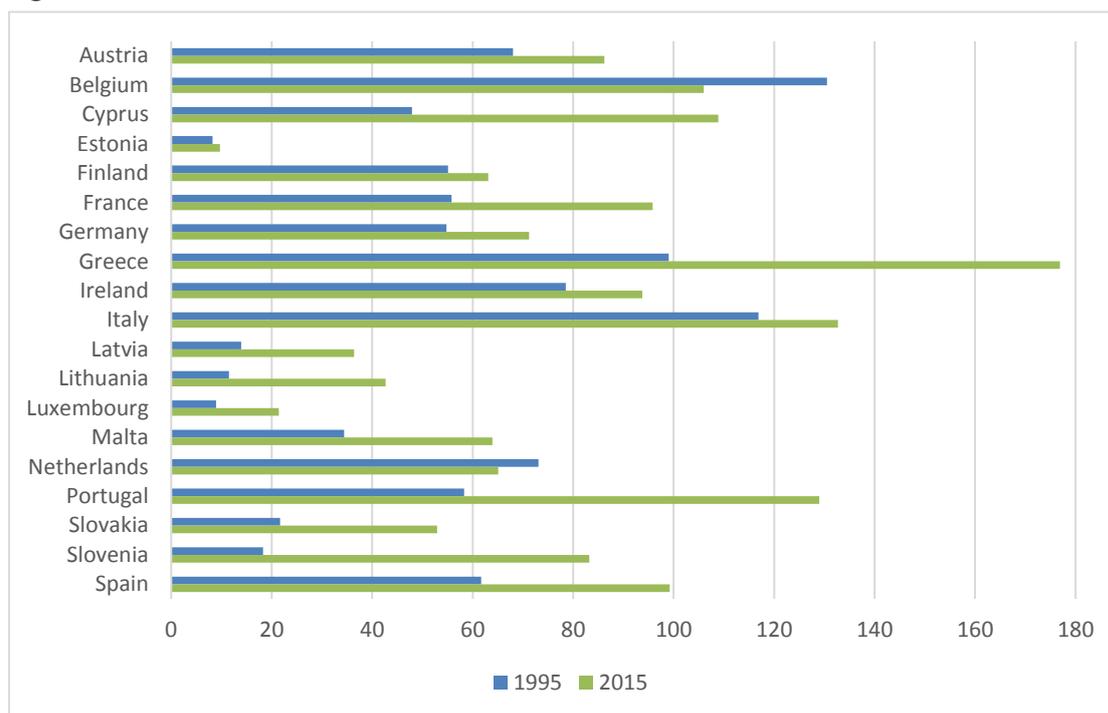
Figure 1 – Debt-to-GDP ratio for the euro area



Data source: Eurostat.

Figure 2 depicts the situation for each euro zone Member State. With the exception of Belgium and the Netherlands, debt in 2015 is considerably higher than in 1995.

Figure 2 – Debt-to-GDP ratios



Data source: Eurostat.

The increase in public debt puts particular pressure on the most indebted countries in term of sovereign solvency (i.e. the future ability to repay debt). A high level of debt makes these countries vulnerable to interest rate increases. A large fraction of GDP must be used for interest debt payments (Table 1),² limiting governments' scope to implement its political program. As an example, Italy paid €68.40 billion³ in interest expenses on its outstanding debt in 2015. In comparison, the Italian budget for education in 2015 was €49 billion, for healthcare €113 billion and the European Union budget in 2015 was €145 billion.

Table 1 – General government net debt interest payment (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Austria	1.1	0.8	0.7	0.4	0.4	0.3	0.3	0.2	0.0	0.0	-0.2	0.1	0.4	0.5	0.5	0.6	0.7	0.6	0.60
Belgium	6.9	6.4	6.2	6.0	5.3	4.9	4.4	4.0	3.7	3.6	3.5	3.4	3.3	3.2	3.2	3.0	2.8	2.6	2.3
Estonia	0.2	0.1	0.1	0.0	0.0	-0.3	-0.2	-0.2	-0.2	-0.4	-0.5	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Finland	1.5	1.4	0.9	0.5	0.0	0.0	0.0	0.0	-0.2	-0.3	-0.5	-0.4	0.1	0.0	0.2	0.1	0.2	0.2	0.1
France	2.9	2.6	2.6	2.6	2.6	2.5	2.5	2.4	2.4	2.5	2.6	2.2	2.3	2.5	2.4	2.2	2.1	1.9	1.8
Germany	2.9	2.7	2.7	2.6	2.5	2.5	2.5	2.4	2.3	2.4	2.3	2.3	2.1	2.0	1.8	1.6	1.4	1.2	1.0
Greece	7.3	7.2	6.5	6.0	5.4	4.8	4.7	4.6	4.3	4.3	4.6	4.8	5.5	6.8	4.5	3.6	3.7	3.4	3.4
Ireland	3.0	2.1	1.6	1.1	1.1	1.1	1.0	0.9	0.7	0.6	0.7	1.4	2.5	2.6	3.2	3.5	3.5	2.8	2.5
Italy	7.5	6.1	5.9	5.8	5.2	4.8	4.5	4.3	4.2	4.5	4.7	4.2	4.1	4.5	5.0	4.7	4.4	4.0	3.7
Luxembourg	-1.0	-0.8	-1.2	-1.3	-1.1	-0.9	-0.8	-0.7	-0.8	-1.0	-1.2	-0.5	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Netherlands	3.5	3.2	2.5	2.2	2.0	1.8	1.7	1.6	1.4	1.3	1.3	1.2	1.1	1.2	1.1	1.1	1.1	0.9	0.7
Portugal	2.7	2.6	2.5	2.5	2.5	2.4	2.3	2.3	2.5	2.6	2.7	2.7	2.7	3.8	4.3	4.2	4.3	4.2	4.2
Slovakia	2.0	2.8	3.0	3.0	2.9	1.6	1.4	1.1	0.9	0.9	0.8	1.1	1.1	1.3	1.6	1.7	1.6	1.5	1.3
Slovenia	1.8	1.9	1.8	1.8	1.7	1.4	1.4	1.3	1.2	1.0	0.7	0.9	1.1	1.4	1.4	2.0	2.7	2.7	2.6
Spain	3.7	3.1	2.9	2.5	2.3	2.0	1.8	1.5	1.3	1.1	1.0	1.3	1.5	2.0	2.5	2.9	3.0	2.7	2.5
Euro area	4.0	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.5	2.5	2.6	2.4	2.4	2.6	2.6	2.5	2.3	2.1	1.9

Source: OECD Economic Outlook 2016 (last updated: 1 June 2016)

According to a recent Bruegel study, ‘Without improving primary fiscal balances, the sustainability of public debt – at least in some advanced economies – can be put into question, especially if current GDP growth rates decline or real interest rates rise (which could happen as a result of any new economic or political shock). In this context, calls for further fiscal stimulus need to be balanced against the potential negative consequences of explosive debt dynamics’.

According to EU rules (i.e. stability and growth pact and fiscal compact),⁴ when the debt level is above the 60 % limit, the evolution of the debt must show a declining trend with an annual rate of 1/20 of the difference between the actual and the 60 % limit. A 2013 OECD study showed that in order to produce a debt reduction, a large and protracted consolidation is necessary, especially for the highly indebted euro area countries.

Theoretical framework for debt restructuring

Several studies were conducted to identify the best way to restructure public debt (reduction in the face value, or lengthening of maturities). A restructuring process can be considered useful because it provides relief for the debtor country, and gains fiscal space for structural reform (i.e. reduces a debt overhang problem).

In a 1988 study, Krugman compares two strategies that can be adopted by a creditor country: providing new lending (at a lower interest rate) or a reduction in the face value (a ‘haircut’). The best option is identified according to debtor conditions, in order to provide the right incentive to repay – and not to write-down (i.e. reduction of value) creditors’ claims unnecessarily.

Reinhart and Trebesch focused on restructurings in the 1980-1990s, as well as in the post-World War I period (1920-1930s) in their 2015 study. Comparing a ‘haircut’ process (i.e. the Brady Plan and the generalised default of 1934) with measures lengthening maturities (i.e. the 1931 Hoover moratorium⁵ and the 1986 Baker plan),⁶ they illustrate that ‘haircut’ interventions produce benefits in term of GDP growth rate for the debtor countries.

Continuing the focus on growth, Forni et al. studied the effects of restructuring procedures between 1970 and 2010. Their 2016 study divides ‘bad’ and ‘good’ restructurings (i.e. ‘restructurings that allow countries to exit a default spell’ and with a low level of debt). In general, they observe that following a restructuring episode, debtor country’s growth rates decline, except in cases of ‘good’ restructurings, associated with increasing growth.

A new theoretical model was provided by Picarelli in 2016, comparing strategies between ‘haircuts’, lengthening of maturities, and conditional additional lending. This model

provides the best options available for both creditor countries (in a debt repayment perspective) and debtor countries (in a growth perspective).

Key restructuring concepts

Restructuring procedures in Russia and Argentina demonstrated that litigation is frequent,⁷ and that coordination problems between creditors (highly likely, due to the widespread number of bondholders),⁸ always imply delays and inefficiency. To solve this problem, the 'contractual approach' to regulate sovereign debt restructuring has already been used. The approach necessitates the introduction of Collective Action Clauses⁹ or CACs,¹⁰ in new debt contracts, defining procedures and conditions for initiating and negotiating a restructuring process. In particular, these clauses, currently embodied in international bonds, allow a qualified majority of creditors to modify bonds' financial conditions. Creditor coordination problems can thus be overcome, and a debt restructuring process facilitated.

Recently, the 'statutory approach' has been widely discussed. In the corporate sector, a bankruptcy procedure has already been established to deal with company defaults (i.e. Chapter 11 for bankruptcy in the United States of America). However, a similar approach is still missing for sovereigns. The Greek situation has highlighted the necessity of developing more specific and detailed instruments in this field, so that orderly default by a sovereign state is possible (contrary to disorderly default). For this reason, the academic and political debate currently focuses on the introduction of a potential sovereign debt restructuring mechanism to deal with sovereign debt crises.

How does restructuring work?

A restructuring process can be implemented in several forms: the main distinction is between **concerted actions** and **market based solutions**. Reduction in the face value (i.e. 'haircut'), lengthening of maturities, lower interest rates, and grace periods from interest payments are examples of concerted actions; examples of market based solutions include debt buy-back and debt swaps (for example, changing floating interest rate debt with low fixed interest rate debt).¹¹

In Table 2, the computations for the **baseline case** (i.e. a case without restructuring) is described. To simplify the calculations, the following assumptions were made: a bullet -- loan with a 20 year maturity, a face value of 1 000 euro and an annual coupon rate of 2 % (interest payments payable at the end of each year). Discount rates considered are 2 % and 5 %. Therefore, 1 000 euro equals the non-discounted amount that must be reimbursed in $t=20$, and 20 the non-discounted yearly interest payment. Using the 2 % discount rate and taking into account time discounting (i.e. 20 years), 1 000 euro becomes 672.97 euro and the sum of each discounted yearly interest payment is 327.03 euro.

Table 2

time	1	2	...	19	20	SUM
payment	20	20	...	20	1 000 (principal) + 20 (last year interest)	1 000 (principal) + 400 (cumulated interest)
PV (2 %)	19.61	19.22	...	13.73	672.97 (principal) + 13.46 (last year interest)	672.97 (principal) + 327.03 cumulated interest
PV (5 %)	19.05	18.14	...	7.91	376.89 (principal) +7.54 (last year interest)	376.89 (principal) + 249.24 cumulated interest

Source: EPRS calculations

Table 3 highlights the effects of different options on the Present Value¹² of debt repayment. The first option aims to provide relief by carrying out a 20 % 'haircut' to the face value. This means that in $t=20$ the debtor country will have to repay 800 euro instead of 1 000 euro, equalling 538.38 euro in present value terms.

In case of a 10 year maturity extension, it is assumed that the final payment of 1 000 euro will take place in $t=30$.

There are two assumptions in the following options: firstly a reduction in the interest rate used to compute interest payments from 2 % to 1 %, and secondly a grace period of five years for the debtor country (i.e. no interest payments).

Finally, a mix of various options provides an alternative case: a grace period for the first 10 years, a maturity extension for 10 years (30 years maturity) and a lower interest rate of 1 %.

Table 3

PV in euro	PV (2 %)			PV (5 %)		
	Total	Principal	Interest	Total	Principal	Interest
Baseline case	1 000	672.97	327.03	626.13	376.89	249.24
Haircut (20 %)	800	538.38	261.62	500.91	301.51	199.39
Maturity extension 10 years	1 000	552.07	447.93	538.83	231.38	307.45
Lower interest rate	844.69	672.97	171.72	507.65	376.89	130.76
Grace period t_1-t_5	922.14	672.97	249.17	551.82	376.89	174.93
Maturity extension 10years+ lower interest rate (1 %) + grace period t_1-t_{10}	686.21	552.07	134.14	307.88	231.38	76.51

Source: EPRS calculations

The examples above demonstrate that restructuring can occur without reducing the principal (or face-value) of the debt.

Different phases characterise a restructuring process:

- **Announcement:** the process usually begins after a default event (post-default restructuring) but there are also cases of pre-emptive restructuring¹³ (usually the debtor country in trouble requests restructuring). The timing of the announcement is important to avoid leaks and market speculation, which could drive market price fluctuation, endangering the restructuring process. Once a decision is taken, swift communication reduces uncertainty and speculation.
- **Negotiation phase:** a long process, which can last for months or years,¹⁴ and usually implies an adjustment programme for the debtor country. A debtor country's debt and its characteristics are evaluated during this phase.

An important distinction exists between domestic (i.e. internal) and external debt holders. The former refers to the part of debt owed to a debtor country's own lenders (households, financial sector); while the latter refers to the part of debt owed to foreign lenders. A restructuring affecting domestic debt, held by domestic holders (e.g. banks), might then produce negative consequences for the debtor country's financial sector. This is why, in some cases, restructuring is only negotiated for a part of a country's debt. This was the case for Belize in 2007 and Ecuador in 1998, where the debtor countries restructured their external debt only.

Several negotiation methods exist for sovereign debt restructuring (Figure 3). The

Figure 3

Sovereign Debt Restructuring by Type of Creditor					
<i>Creditor</i>	Commercial Banks	Bondholders	Bilateral (Governments)	Multilateral (World Bank, IMF)	Suppliers, Trade Creditors
<i>Restructuring Vehicle</i>	London Club (Creditor Committees)	Exchange Offers	Paris Club	Preferential Treatment; Restructuring only for poorest countries	Ad hoc

Data source: Das et al (2012).

most important are: 1) the [London Club](#)¹⁵ and 2) the Paris Club.¹⁶ The first is used for restructuring processes with private creditors (e.g. banks and bondholders), whereas the second deals with public claims (i.e. official creditors).¹⁷

- **Debt Exchange:** at the end of negotiations, a restructuring offer is formulated and the creditors decide whether to accept or reject it. There is usually a minimum threshold that must be reached in terms of accepting creditors in order to proceed with the restructuring.

Potential costs and benefits

Table 1 – potential benefits and costs of a restructuring process

Debtor (a)		Creditors (b)	
Benefits	Costs	Benefits	Costs
Reducing debt overhang	Moral hazard	Avoiding default	Credits losses
Reduce uncertainty	Reputational and other costs	Reduce uncertainty	

Source: EPRS

Reducing debt overhang

a) A debt overhang condition implies that a high level of debt reduces incentives to invest in a specific country. In other words, debt is perceived as a (future) tax on the economy:¹⁸ the higher the debt, the higher the (future) tax that must be paid. From a corporate viewpoint, a high tax rate means lower profits, which in turn, means lower investment returns and thus reduced incentives to invest. As a consequence companies delay and/or reduce investments, ultimately affecting the country's growth rate and prospects. This reduction in investment, which will in turn impact the economic sentiment of operators, could finally lead to a period of prolonged low-investment and low activity. From a citizen's viewpoint, high debt means higher future taxes and/or reduced social benefits – and when combined with reduced corporate activity – less employment.

Two different impacts have been studied in literature: the direct and the indirect. The direct effect refers to the impact debt has on investments,¹⁹ whereas the indirect effect refers to the link between debt and growth. Different thresholds have been found in order to explain the link between debt and growth.²⁰ It is believed that, if debt to GDP ratio is larger than a specific threshold, then the debt negatively affects future GDP growth rates.

The debt overhang theory can also be considered in a sovereign context.²¹ In this case it is possible to claim that a high debt level reduces the incentives for a debtor country, struggling with debt sustainability problems, to undertake the necessary adjustment policies (i.e. structural reforms). These kinds of reforms are costly (politically and financially – at least in the short term), benefits will only occur after a certain time, and they are often difficult to implement. However reforms are necessary to sustain an appropriate level of GDP growth (assuming that a certain debt-to-GDP level has been passed).

b) From a creditor's perspective, the implementation of structural reforms can be beneficial for two reasons. Firstly, structural reforms could lead to a positive reaction in the financial markets, reducing potential turmoil during crisis periods. Secondly, the implementation of structural reforms could generate an increase in the market value²² of creditors' exposures toward the debtor country, since its default risk probability would be reduced. Consequently, to speed up the transformation of the debtor country's structures, it might be useful to consider debt reduction as one of the macro-tools within the EU's toolbox.

Reducing uncertainty

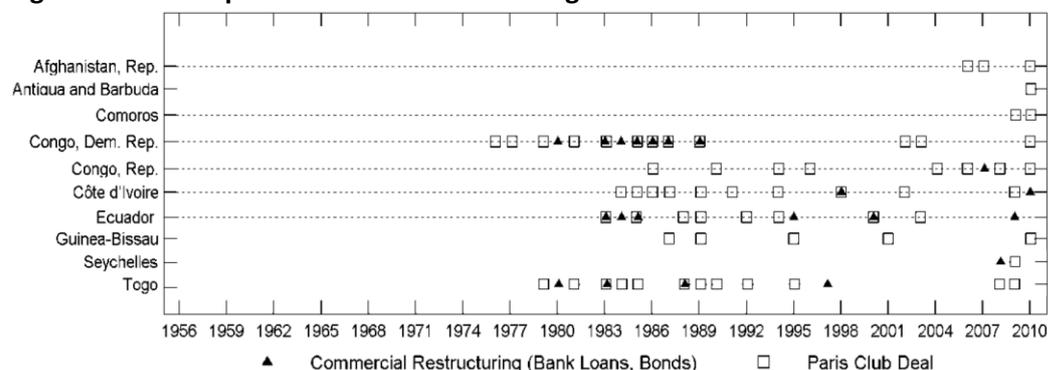
- a) Debt relief might produce positive consequences by reducing the uncertainty level. Indeed, a large amount of outstanding debt creates uncertainty about government's future policies, since the debt servicing obligation will need to be met. As a result, economic agents will be inclined to postpone their investment decisions. Creditors would suffer a reduction in the market value of creditor exposure toward the debtor country, as high uncertainty might imply increased default risk. In this context, a debt relief measure would help to restore normal conditions in the financial markets (i.e. markets do not like uncertainty). In particular, it would avoid a debtor country default, with all the attendant negative consequences and costs for creditor countries (e.g. market distress, delayed payments as per Argentina's default).

Moral hazard

- a) Theoretically, a highly indebted country has two options when its debt becomes unsustainable: to declare default and/or restructure its debt (the second option requires the creditors' agreement). Several episodes of both defaults and restructurings have occurred in the past.

Evidence from past experience shows that, in the case of default, it takes a long time to reimburse creditors, and the amount they receive is very low (because of currency devaluation and/or high inflation). This is the main reason why creditors might prefer a restructuring process; a deal with the debtor country in which an agreement is reached on the new amount of and conditions for debt reimbursement could lead to higher returns compared to the default option. Debt restructuring might also be the

Figure 4 – Serial episodes of debt restructuring - extract of ten most recent cases



Data source: [Trebesch \(2011\) - full list of debt restructuring episodes.](#)

preferred option for the debtor country. Indeed, it gives the debtor the possibility to avoid/mitigate the entire cost of the default, which the debtor would otherwise have to bear (see below).

Since debt restructuring seems to be the dominant strategy (rather than the default), expectation of future restructuring might motivate a debtor country with a high debt level to accumulate even more debt. In such a situation, the debtor country's incentive to undertake structural reforms (necessary for future growth) might be reduced and a sort of vicious cycle might arise. As illustrated by Das et al in 2012 (Figure 4), many countries have experienced repeated debt relief interventions over time,²³ where this pattern of debt relief might be due to slow structural change linked with a low incentive 'to adjust' (i.e. to undertake structural reforms).

From a creditor's perspective, restructuring makes sense (regardless of any potential future benefits), only when creditors can trust that the restructuring deal will be

respected.

Reputational and other costs

a) In economic literature, reputational costs, market exclusions, borrowing costs, sanctions, trade embargo, asset confiscations (sovereign assets outside the country) are examples of costs that a debtor country might suffer in case of default. It is possible to claim that some of these costs might affect a debtor country even with debt restructuring, although in a lighter form.

- **Reputational costs**

Two kinds of reputational costs can be considered:

- i. **Market exclusion:** creditors might refuse to purchase the debtor country's bonds following debt restructuring.²⁴ Creditors impose this punishment on the debtor country. In 2013, Cruces and Trebesch proved a positive correlation between market exclusion and a haircut's size: a 1 % increase in the haircut size implies a 2.4 % higher probability of market exclusion for the debtor country.
- ii. **Borrowing costs:** creditors might purchase the debtor country's bonds following debt restructuring, but request a premium (i.e. a higher interest rate to compensate the risk of future default or other restructuring).²⁵ In 2013, Cruces and Trebesch found that higher interest rate spreads compared to debtors without debt restructuring are associated with higher debt relief received.

- **Trade sanctions**

Creditors might decide to reduce their international trade with a debtor country or to impose sanctions following debt restructuring. There may be two reasons for this: 1) because the creditors want 'to punish' the debtor country; 2) because the debtor country's reliability following restructuring is so low that the creditors prefer to avoid trade relations.

- **Banking system**

If domestic banks hold a large amount of outstanding debt, debt restructuring might endanger the domestic banking system, due to write-downs. Financial institutions need to compensate accounting loss by using capital buffers, capital increase, or balance sheet size reduction. This could lead to increased domestic lending rates and/or decreased domestic lending, which will in turn have negative consequences for the entire economy.

Credit losses

- i) Accepting a restructuring agreement implies that the creditors will suffer a reduction in payments from the debtor country. In the case of a public sector creditor, debt write downs might cause increased political tension.

Past experience

There have been several sovereign debt restructuring episodes (Figure 4). The most significant were:

1. Germany

Following World War II, Germany benefitted from a significant debt relief in 1953 (London Debt Agreement) that contributed to its post-war growth, creating fiscal space, lowering borrowing costs and normalizing inflation.

2. Brady Plan

In the 1990s, many less developed countries experienced debt problems. On the one hand, the Brady Plan provided a debt 'haircut', and on the other, it required the debtor countries to implement structural reforms. The plan was successful for many countries, notably because it restored the inflow of capital and produced stock market appreciations in both creditors and debtor financial markets.

3. Russia

In 1998, Russia defaulted on the debt it inherited from the Soviet Union. A restructuring agreement was reached with its creditors in 1999 and it combined debt restructuring with capital controls. Investors lost between 41 % and 55 % of their pre-existing claims. (In May 1998, Russian government bond yield was 47 %).

4. Argentina

Following the 2001 default, Argentina reached an agreement on the restructuring of its debt (US\$82 billion), in January 2005. The deal implied a debt repayment of 30 % of the face value and a lengthening of maturities. A second restructuring was implemented later in 2010 for those who did not participate in the first agreement (although some held out).²⁶

5. Greece

After a first bailout in 2010, Greece experienced the largest restructuring operation in the history of sovereign debt (over 50 % of its 2012 GDP of around €191 billion) in March 2012. The debt reduction was more than 50 % for private creditors and also implied a lengthening of maturity. In total, since 2010, Greece has obtained around €200 billion of new concessional lending²⁷ from supranational institutions.

A European sovereign debt restructuring mechanism

Europe has no general framework to regulate sovereign debt restructuring — regardless of the form of restructuring that could be used.

Originally, the idea of a **Sovereign Debt Restructuring Mechanism** (SDRM) was proposed by Anne Krueger in 2002, following the Argentinian default, to ensure an orderly restructuring and to reduce costs. This idea was also discussed by the [German Council of Economic Experts](#) in 2016, [which](#) proposed a two-step mechanism to deal with debt crises, and by Gros in 2010, who proposed the introduction of a **European Monetary Fund**. It is considered that the introduction of a sovereign restructuring mechanism might be useful to avoiding that the financial distress of one single country could compromise the stability of the whole European Union (through a contagion effect). In particular, defining the bailout procedures in advance would be beneficial in term of reducing the uncertainty level. A well-defined restructuring process should anchor market participants' expectations, thereby reducing excessive markets reactions (i.e. volatility).

According to Gros' proposal, in exchange for adjustments measures/structural reforms (i.e. 'conditional support'), the fund should provide financial support for troubled euro

area Member States. This would avoid moral hazard for the debtor country, which otherwise might be incentivised to continue accumulating new debt.

A controversial aspect would be this fund's financing mechanism. According to the original proposal, countries that break the Maastricht criteria should fund the fund. Ex ante, this would motivate respect for the fiscal rules, but ex post, might be considered a pro-cyclical measure that would lead to requests for contributions from countries under fiscal\financial stress, aggravating their position.

In 2012, the European Parliament discussed a mechanism to provide Member States with time to stabilise their economic situation and to be able to honour their debt. The discussion took place in the context of the 'two pack' legislative process. A new rule would have empowered the Commission to place a country on the verge of default under legal protection, to provide more clarity, stability and predictability in tackling its problems. Once under such protection, a country could not be declared in default, its creditors would need to make themselves known to the Commission within two months, and loan interest rates would be frozen. However this concept was not included into the final legislation.

Conclusions

The current situation in the euro area, characterised by high levels of debt; the continuing trend of many Member States to run budget deficits; combined with a low growth environment; raises the issue of debt sustainability. In addition, the low level of inflation recorded in recent years (and deflation in some cases) has played an important role in the increase of debt burdens.

The lack of an EU level transparent framework for sovereign debt restructuring could potentially entail higher additional costs. As part of the EU's financial stability management instruments, sovereign debt restructuring could form a part of the EU toolbox. As demonstrated with a simplified example, there are several measures that can be implemented to provide debt relief for a debtor country struggling with unsustainable debt levels. Therefore, a 'haircut' (i.e. reduction in the face value of debt), is not the only option that could be considered. The different options (and their combination) could be considered as alternative measures for the provision of debt relief, in present value terms, to a debtor country.

Debt restructuring actions need to be accompanied with appropriate measures to minimise moral hazard risk. It is also important that a debtor country implements measures through which the long term sustainability of public finances can be restored, thereby minimising the risk of future restructuring.

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Endnotes

- ¹ Das et al (2012).
- ² Thanks to the reduction in government bond yields, partly due to ECB policy measures, interest payments decreased in recent years.
- ³ Source: Bank of Italy.
- ⁴ De Finance, S. (2016) 'Fiscal Compact Treaty: Scorecard for 2015'.
- ⁵ In order to postpone World War I payments by one year.
- ⁶ This was the first attempt to solve the less developed country debt crises (before the Brady Plan), and provided new lending in exchange for structural reforms such as privatisation, openness to foreign direct investment, etc.
- ⁷ Especially in the presence of '[vulture funds](#)'.
- ⁸ The 2005 Argentinean restructuring involved around 600 000 investors.
- ⁹ Known as 'collective action clauses' (i.e. CACs).
- ¹⁰ Eichengreen, Portes (1995), 'Crisis? What crisis? Orderly workouts for sovereign debtors'; Rey Report (1996), The resolution of sovereign liquidity crises, Report to the Ministers and Governors of the Group of Ten; Haldane et al (2003), '[Analytics of sovereign debt restructuring](#)'.
- ¹¹ According to Das et al (2012), there have been 57 haircuts, 129 lengthenings of maturities and 26 buybacks between 1950 and 2010.
- ¹² PV is a calculation that expresses the future value of money as today's terms (i.e. it is discounted).
- ¹³ A debt repayment default (principal or interest). When these become due, they will trigger credit rating agencies to set the rating for this specific debt issue as 'default'. Due to the existence of *pari passu* clauses, all existing debt belonging to a single issuer will default simultaneously.

- ¹⁴ This is particularly true for non-CAC bonds because **vulture funds'** usual strategy is to block the negotiation by suing the debtor country to obtain the full repayment in the end.
- ¹⁵ Neither a statutory organisation, nor a real club.
- ¹⁶ The Paris Club is merely an informal group of creditors. It has no legal status.
- ¹⁷ Between 1950 and 2010 there have been 186 agreements via the London Club, and 447 via the Paris Club (Das et al, 2012).
- ¹⁸ Theory introduced by Myers (1977), '[Determinants of Corporate Borrowing](#)'.
- ¹⁹ See Deshpande (1997), '[The Debt Overhang and the Disincentive to Invest](#)'.
- ²⁰ See Reinhart and Rogoff (2009), '[This Time is Different: Eight Centuries of Financial Folly](#)'; Reinhart et al. (2012), '[Public debt overhangs: Advanced economies episodes since 1800](#)'; Pattillo et al. (2011), '[External Debt and Growth](#)'.
- ²¹ Obstfeld, Rogoff (1996), '[Foundations of International Macroeconomics](#)'; Krugman (1988); Borensztein (1988), '[Debt overhang, credit rationing and investment](#)'.
- ²² Here, we assume that the market value of outstanding debt is less than the face value, due to increased default risk.
- ²³ Serial restructuring as serial default.
- ²⁴ Greece lost its access to the financial markets in April 2010; Argentina had the possibility to re-access to the financial markets only in April 2016 following its 2001 default.
- ²⁵ Panizza and Borensztein (2008) carry out this analysis for cases of default.
- ²⁶ Not all the creditors accepted the restructuring terms and they retained their legal right to demand a full debt repayment. The ruling in [Argentina v. NML Capital](#) (August 2013), determined that holdouts have to receive the total face value, which led to Argentina being forced [to pay](#) after almost 14 years
- ²⁷ Lending at a low (i.e. **concessional**) interest rate.

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