BRIEFING

Single-limb collective action clauses

A short introduction

SUMMARY

Sovereign bonds, the most common form of sovereign debt, have specific characteristics. They are issued by national debt management offices on the primary market and subsequently traded on secondary markets.

Loan agreements signed at the issuance of sovereign bonds on the primary market may include collective action clauses (CACs) aimed at making restructuring more orderly and predictable. CACs have been included in loan agreements and bond contracts since the 1990s. These clauses enable a 'supermajority' of creditors to modify essential payment terms of the contract, thus overcoming the problem posed by holdout creditors.

Indeed, while debt restructuring involves benefits for both debtor countries and their creditors, there are also incentives for both parties to delay the process. Certain creditors, for instance, are tempted to hold out, and are therefore referred to as holdout creditors. Their incentive for holding out is the chance that they might recover their investment either in full or in a higher amount than the debtor country has offered in the restructuring agreement. While a holdout can bring creditors great gains, it has significant negative consequences for debtor countries and, in the worst case, can jeopardise the restructuring process.

CACs can have one or two 'limbs'. While the EU Member States that are in the euro area decided in 2011 to include two-limb CACs in sovereign debt issued after 2013, the Greek restructuring experience and recent New York court decisions relative to sovereign debt have shown that such CACs can protect sovereign debtors only up to a certain point. Therefore, in the context of the euro-area governance reform, the Eurogroup has proposed that euro-area leaders should work for the introduction of single-limb CACs by 2022, and included this commitment in the draft revised text of the European Stability Mechanism Treaty.

In this Briefing

EPRS | European Parliamentary Research Service

Author: Angelos Delivorias
Members' Research Service

PE 637.974 – July 2019

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Introduction

The European sovereign debt crisis brought to the fore the need to enhance the financial architecture of the euro area so as to prevent and manage financial crises in the EU, as well as to create instruments to deal with crises that could not be prevented or contained. With this aim in mind, EU leaders and institutions enhanced the governance framework of the euro area and introduced various crisis prevention and resolution mechanisms, such as the macroeconomic imbalance procedure, the banking union and the European Stability Mechanism (ESM). Despite all these measures, the Greek crisis of 2012 showed that sovereign debt restructuring could not be ruled out. Among the relevant steps taken in the euro area was the introduction in the ESM Treaty (in force since September 2012), of collective action clauses (CACs) for euro-area sovereign bonds issued after 2013. At its meeting in December 2018, the Eurogroup announced that the EU would pursue single-limb CACs and introduce them by 2022. And at its meeting of 14 June 2019, it introduced this in the draft revised text of the treaty establishing the European Stability Mechanism.[1]

Sovereign bond issuing

In many developed countries, the government issues sovereign debt[2] for a variety of reasons, including fiscal stimulus and asset management (as well as to cover budget deficits and refinance debts).[3] There are two main forms of borrowing by governments: debt securities and loans,[4] the fundamental difference between them being the former's tradability.[5]

Sovereign debt securities (government bonds) are the most common form of debt for most countries ('sovereigns'). Besides including a promise to repay an amount at maturity, they also typically include a fixed interest rate and, based on that, periodic (e.g. semi-annual, quarterly) interest payments called 'coupons'. The bond's yield is the interest the government is willing to pay on the bond plus an extra element.[6] Bond yields depend on a variety of factors, including a country's exchange rate, its rate of growth, but also the degree of political stability it enjoys and its adoption of responsible and sustainable economic policies. Sovereign bonds can be short-, medium- or long-term instruments. They can be issued either at their face value or below or above it,[7] and they can be linked to an index.[8] They can be denominated in the local or a foreign currency (usually global reserve currencies, such as the US dollar or the euro). They can be issued to creditors within the country or to external creditors. Lastly, they can be issued under national or foreign law. Domestic-law bonds are deemed to have weaker legal protection, since the contract terms can be altered retroactively by changes in the legislation of the debtor country.[9] No retroactive changes can be made to foreign-law bonds, because legislation adopted by national parliaments has no authority beyond domestic borders.

In the euro area, government bonds are typically issued by national debt management offices, by means of a public auction. Issues of government bonds take place on the primary market around primary dealers (see here the Member States' individual lists of primary dealers), who are bound by certain obligations.[10] Primary dealers are the crucial link between primary and secondary markets, deriving compensation for their services and risk-bearing through the spreads they charge. After being issued on the primary market, sovereign bonds are then traded on the secondary market.[11]

Whereas equities (stocks) only have a single issue, government bonds have many outstanding issues of varying maturity, currency and type (e.g. 'bullets', 'linkers'). Each bond issue is governed by a separate bond contract. Typically, each bond series has a different maturity date and coupon rate, which are specified in the term sheet of the contract.

Sovereign debt restructuring

Under normal circumstances and with the help of a prudent debt-management policy, a country should be able to service its debts (i.e. to repay what it owes at maturity). At times, however, a country can no longer service a part (as is usually the case) or the entirety (as is rarely the case) of its debt, due to poor fiscal management or to external factors. It is accepted international practice[12] that such a country can negotiate with its creditors to restructure its debt in order to bring it down to a sustainable level at the lowest cost to both itself and its creditors. From the country's perspective, a restructuring involves reputational damage and loss of access to international capital markets, while for its creditors it means losing a part, or all, of their initial investment. At the same time, there is an upside for both, provided that the process is fluid and timely. Arguably, a restructuring can create the necessary conditions for the country to overcome its crisis and set its finances on a more sustainable path. In the same fashion, it can help creditors to contain their losses (as without a restructuring the country's conditions could deteriorate further, hindering debt repayment even more). That said, given the nature of the exercise, both sides might have reasons to want to delay or avoid altogether the process of restructuring. Debtors might seek a delay so as to avoid the political consequences or the reputational cost and the loss of capital markets. Creditors' reluctance to go ahead with a restructuring might be due to their fear of incurring losses on their investments, or of facing competition from potential holdout creditors.

Holdout creditors

For a debt restructuring to be effective in restoring debt sustainability, a sufficient majority of creditors must agree to a reduction in their claims. As mentioned above, there are reasons both for and against them agreeing. Given, however, that the debtor country often lacks the resources to repay all of its debts on their original terms, an orderly restructuring is in practice the only solution for most creditors. Some of them, however, choose instead to break ranks with fellow creditors and to *hold out* from the main restructuring exercise, expecting that they will be able to recover their claims in full (or at least to a greater degree than what they would recover if the restructuring were to take place). Indeed, if the debtor country receives debt relief from most of its creditors, then its finances should be enough to repay in full those that decline to join the restructuring and threaten to pursue legal remedies. While therefore it is in the best interest of all creditors to participate in the debt restructuring, from the perspective of each individual creditor, the best outcome is if everyone else participates and they successfully hold out.

Holdout creditors can attempt to recover their claims by taking, or threatening to take, legal action in the courts of the country whose laws govern the relevant sovereign bond contract.[13] As mentioned above, bond contracts can be governed either by the domestic law of the country or by a foreign legal system (usually the legal system of the United States or the United Kingdom, as they are the main foreign financial centres where sovereign bonds are issued).[14] As already mentioned above, while domestic-law bonds can be subject to retroactive changes that may affect the creditors' ability to bring legal action against a sovereign (see Section on the 2012 Greek restructuring below), foreign-law bonds are much harder to modify – at least, by the debtor country.

Holdout creditors can cause the following problems: i) they can block the restructuring (or diminish its value significantly), if there are enough of them; ii) if they are paid in full, they create incentives for more holdouts in future restructurings; iii) if they are not paid, they constitute an ongoing litigation threat to the sovereign debtor.[15]

Collective action clauses

Collective action clauses are clauses in loan agreements and bond contracts that typically enable a 'supermajority' of creditors[16] that are parties to any such contract, to modify essential payment terms, such as the bond's amount of principal owed, the interest rate, or the maturity(ies). While the concept of CACs was already in existence in the early 20th century, CACs received their first formal backing from the international community in a 1996 G10 report supporting the view that 'certain contractual or statutory provisions governing debt contracts can facilitate the resolution of a crisis by fostering dialogue and consultation between the sovereign debtor and its creditors ... and by reducing the incentive for, or ability of, a small number of dissident creditors to disrupt, delay or prevent arrangements to support a credible adjustment programme that is acceptable to the vast majority of concerned parties'.

Advantages and disadvantages

The benefits of including CACs in sovereign-bond contracts are that: a) they provide issuers with flexibility in managing the crisis (by modifying the aforementioned essential contract terms) and with the means to manage holdout creditors; and b) they provide collective representation to bondholders.

On the other hand, CACs can have limitations. One of these is that each bond issue has a specific group of creditors, and the CACs in a particular contract can only apply to the creditors of that contract. Thus, for a comprehensive exchange offer in which the entire sovereign debt obligation is sought to be restructured, the sovereign effectively needs to appeal to each bondholder group separately. Another disadvantage is that, because bonds may be issued in different jurisdictions and currencies, creditors of different jurisdictions may not respond to the bond terms offered in the exchange offer. A third drawback is that, 'even though a supermajority assigned for the voting procedures of restructured bonds may preclude holdout creditors from stopping a restructuring, their claims against the sovereign for the old securities that they retain continue to remain and the sovereign is obliged to honour them, eventually'.[17]

Relevant EU action

In April 2003, the EU Member States decided to include CACs in their international debt issuance to promote international efforts for orderly restructurings in the event of sovereign debt crises. Following this, in September 2003, the Economic and Financial Committee agreed on a set of core CACs to be included in the documentation accompanying the debt issuance. However, this initiative was not evenly implemented across the Member States, as it was not of a compulsory nature.

In the midst of the euro-area crisis, the 24-25 March 2011 European Council meeting decided to include CACs in all new euro-area sovereign bonds with a maturity of more than one year, as from July 2013. The CACs would be identical and standardised for all euro-area Member States; furthermore, they would be based on the CACs that are commonly used in the US and the UK markets and are governed by the two countries' respective laws.

These CACs were developed and agreed by the EFC in November 2011 and were subsequently included in the ESM Treaty (Article 12(3)). This 'euro area model CAC 2012' relies on a 'two-limb' voting structure. Specifically, a minimum threshold of support must be reached *both in each bond series* (66⅔ % of the outstanding principal) *and across all series* subject to the restructuring (75 % of the outstanding principal). Such a dual restructuring vote requires an aggregate vote[18] of the bondholders of the relevant debt, as well as an individual bond-by-bond vote. Given, however, that most CACs are only binding across a single-bond series, and – as mentioned above – countries usually borrow through multiple-bond series, it is still possible under those new CACs for holdout creditors to accumulate a sufficiently large share to block the activation of the CAC in a particular series. In case they do, that particular series is excluded from the restructuring, while the remaining series are restructured so long as the two-limb voting thresholds are met.

The 2012 Greek debt restructuring

At the high point of the Greek crisis, following several months of discussions between the Greek authorities and the creditors and the 26 October 2011 Euro Summit, Greece and the 'creditor committee' announced that they had reached an agreement on a deal on voluntary private sector involvement[19] (PSI). Under this deal, Greece offered private-sector bondholders a swap for their bonds to a bundle that included: i) 15 % of the face value in the form of cash-equivalent European Financial Stability Facility (EFSF) notes maturing within 24 months; ii) 31.5 % of the face value in the form of new UK-law bonds with a maturity of up to 30 years; and iii) detachable GDP-linked securities (warrants), designed to give bondholders the potential right to receive an additional amount (up to 1 %) in the coupon on the new principal, under the condition that growth and nominal GDP would exceed a specified path as from 2015.

Prior to the bond swap, Greece's outstanding government debt was €356 billion, of which €205.5 billion (57 %) was eligible for the exchange.[20] The exchange offer successfully closed on 8 March 2012.[21] Meanwhile, to increase participation, on 23 February 2012 the Greek Parliament approved Law (4050/2012), retroactively introducing CACs with aggregation features in its outstanding Greek government bonds. Given that more than 66 % of domestic-law bonds were tendered, minority holders were also forced to exchange their bonds and accept the associated reduction in value (haircut), even if they had voted against the offer. In total, the participation rate in the Greek swap reached 96.9 % (€199 billion) of the total outstanding amount of bonds eligible for the exchange, worth €205.5 billion. In net present value (NPV) terms, losses ranged from 59 % to 65 %, while in nominal terms the haircut amounted to 53.5 %.

While this happened to bonds under Greek law, the terms for foreign-law bonds were not altered (as explained earlier, the Greek Parliament could not alter retroactively, on its own initiative, contract terms under UK/US law). This allowed creditors holding them to reject the exchange offer and to hold out. The result was that more than 50 % of Greek bonds under UK, Swiss and Japanese law were not restructured. While the reduced amount of foreign-law bonds offered in the PSI meant that the holdout creditors could not present a problem to the completion of the Greek debt restructuring itself (out of the €206 billion worth of debt that Greece attempted to restructure, €21.6 billion was subject to foreign law, and at the end €6.5 billion was not restructured), it was feared that their success would encourage larger creditors to acquire blocking positions in foreign-law bonds. Even the aggregation feature included in the 'euro area model CAC 2012' was deemed weak, as the aggregate voting threshold is high (75 %) and 66.67 % is needed in each bond issuance.[22] In addition, there is the belief – as much related to Greece as to any other country grappling with restructuring – that, specific decisions that have been adopted by the New York Court in the past few years, pose a significant risk of complicating the sovereign debt restructuring process.[23]

In this context, academics have proposed other ideas to deal with the problem of holdout creditors. A first group proposed to amend the ESM Treaty in order to extend immunity from legal process to Member States whose debt restructuring has been negotiated in the context of an ESM programme and/or agreed by a (super)majority of creditors.[24, 25] Others argued instead for a broader, treaty-based legal procedure resembling corporate bankruptcy, which would involve a sovereign bankruptcy court (for example, a chamber of the European Court of Justice). Decisions taken by that court would be binding on all creditors.[26, 27] Despite their ambition and interest, however, these ideas were not pursued.

Latest developments

In 2014, a 'single-limb' clause was developed by a public-private sector expert group led by the US Treasury. This clause, as detailed in an IMF staff report, allows one vote to be taken on all of the relevant debt and to restructure all relevant bonds if a threshold is reached. According to its proponents, the single-limb methodology is preferable to the two-limb one, as it helps tackle the holdout creditor problem and thus to limit ensuing litigation. To counter the problem of inter-creditor equity, the CAC contained in the International Capital Markets Association (ICMA) model clauses requires all bondholders to receive bonds whose terms are uniformly applicable (same terms/identical provisions).

Following the Greek restructuring episode and in the wider context of euro-area reform, this idea was included in the 19 June 2018 Meseberg Declaration, which included a proposal to 'start working on the possible introduction of Euro CaCs with single-limb aggregation', in order to 'improve the existing framework promoting debt sustainability and to improve their effectiveness'. Despite their opposition to most points of the Meseberg Declaration, the Member States within the 'New

Hanseatic League' accepted in their shared views in November 2018 that 'The introduction of single limb CACs, with proper safeguards to ensure smooth market conditions, is an important element to increase the predictability' of the EMU crisis-management framework. This led the Eurogroup to state in its December 2018 report to leaders on EMU deepening, that 'We intend to introduce single limb collective action clauses (CACs) by 2022 and to include this commitment in the ESM Treaty'; these CACs would slowly replace the euro-area model CACs.[28]

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ENDNOTES

1. According to article 12 (4) of the draft revised ESM Treaty 'Single-limb aggregated voting shall apply to all new euro area government securities, with maturity above one year, issued on or after 1 January 2022'.
2. For the broader question of what is encompassed by the concept 'sovereign debt', see S. Arsanalp *et al* 'The current landscape', IMF, 2018, pp.4-6.
3. See table containing data on the total outstanding government debt securities of the individual EU Member States prepared by the Economic and Financial Committee.
4. Arsanalp *et al.* include in the latter 'loans from domestic and foreign commercial banks, and bilateral loans from foreign governments and their lending arms (such as development banks), as well as from international financial institutions like the European Investment Bank, or World Bank'.
5. Arsanalp *et al.* also note that it is recognised, however, that a government can incur additional liabilities – such as financial derivatives or pensions – that should also be taken into account.
6. The yield also includes a component that is the difference between the face value of an issuance and the actual price paid by investors.
7. Respectively 'at par', 'at a discount' and 'at a premium'.
8. For example, to the value of the consumer price index.
9. M. Chamon *et al* note that 'Through an act of parliament, governments can, in principle, change the currency denomination of domestic-law bonds, their payment terms, or the voting rules for a potential restructuring'.
10. These obligations differ from country to country, but usually include participating in the auctions, placing the government securities and maintaining a liquid secondary market, by making continuous bid–offer prices. PDs also have a reporting obligation towards the respective debt management offices (DMOs) on all outright purchases and sales in government securities.
11. For more information on secondary market turnover in 14 sovereign and two supranational securities markets in the euro area, see the Economic and Financial Committee's annual Euro Market Activity Report (EMAR). For data on government bond markets, see the Association for Financial Markets in Europe's Government Bond Data Report (most recent edition: Q3 2018).
12. T. Strickland notes: 'From 2004 to 2014, 14 countries have undertaken a total of 18 debt restructurings. These countries are Argentina (2005, 2010), Belize (2007, 2013), Cameroon (2005), Dominica (2004), Dominican Republic (2005), Ecuador (2009), Greece (2012), Grenada (2005), Côte d'Ivoire (2010, 2012), Jamaica (2010, 2013), Nicaragua (2008), Paraguay (2004), Seychelles (2010), and St Kitts and Nevis (2012)'.
13. In the extreme, vulture funds have used litigation as an investment strategy, by purchasing distressed sovereign bonds on the secondary market at discounted prices (e.g. at 70 % of face value), with the aim of litigating in order to obtain the (full) face value of the bonds following a country's default or a restructuring of its debt.
14. IMF analysis suggests that the value of the stock of outstanding international sovereign bonds in 2014 was approximately US$900 billion. T. Strickland estimates that this is equal to 1.5 % of global government debt. He further notes that it is estimated that 90 % of these sovereign bonds are governed by US or UK law.
15. An example is Argentina's decade-long legal fight with thousands of holders of Argentine bonds that went into default in 2001.
16. J. Dey clarifies the term as 'some percentage of creditors higher than a simple "greater-than fifty-percent" majority'.
17. For more information, see Lee C. Buchheit and G. Mitu Gulati 'Sovereign bonds and the collective will' and Joy Dey 'Collective Action Clauses Sovereign Bondholders Cornered'.
18. Traditional CACs require separate votes for each bond series, while more recent CACs allow for aggregation features. Aggregation is important, as it makes it more difficult for holdout creditors to obtain blocking stakes in a particular series.
19. The term 'private sector involvement' is generally understood to refer to measures to 'bail in' private creditors in the context of the resolution of a sovereign debt crisis. For more information, see the IMF's 2001 factsheet, 'The IMF and the Private Sector'.
20. According to the OECD, 'T-bills, official sector loans, and ECB's holdings of Greek bonds were exempt from the swap'.
21. It is interesting to note that less than a week later (14 March 2012), euro area finance ministers approved the financing of the second economic adjustment programme for Greece.
22. It seems that the two-limb CAC was adopted over fears that the debtor country and its largest creditors could abuse small creditors in the restructuring process.
23. For the New York Court decisions relative to the Argentinian sovereign debt restructuring, see 'Sovereign debt restructuring – recent developments and implications for the Fund's legal and policy framework', IMF, 2013.
24. The authors propose the following amendment to the ESM Treaty: 'The assets and revenue streams of an ESM Member receiving stability support under this Treaty which are held in, originate from, or pass through the jurisdiction of an ESM Member shall not be subject to any form of attachment, garnishment, execution, injunctive

relief, or similar forms of judicial process, in connection with a claim based on or arising out of a debt instrument that was eligible to participate in a restructuring of the debt of the beneficiary ESM Member after the effective date of this Treaty. (...) The immunities provided in the preceding paragraph shall automatically expire when all amounts due to the ESM from the beneficiary ESM Member have been repaid in full'.

25 'A new provision should grant immunity from creditor attachments to the assets of euro area countries which participate in an ESM-supported adjustment program. Such an amendment would be sufficient to comprehensively exclude legal risks.'

26 'We propose in this paper the creation of a European Crisis Resolution Mechanism (ECRM) consisting of two pillars: A procedure to initiate and conduct negotiations between a sovereign debtor with unsustainable debt and its creditors leading to, and enforcing, an agreement on how to reduce the present value of the debtor's future obligations in order to re-establish the sustainability of its public finances. This would require a special court to deal with such cases. The Court of Justice of the European Union is the natural institution for this purpose and a special chamber could be created for that purpose (...) Our suggestion is that the legal role would be assigned to the Court of Justice of the EU, whose mission is to ensure that 'the law is observed' in the interpretation and application of European treaties, to a specialised chamber within the court or, if preferred, to an entirely new institution.'

27 'The Resolvency Proceeding proposal shares with many others the commonality of establishing a court-like institution as it was meant to be with the IMF's Sovereign Debt Tribunal' (see the IMF's Sovereign Debt Restructuring Mechanism). 'The said court would be in charge of managing, monitoring, and directing the proceeding. The specific peculiarity of this approach lies with the fact that, on the one hand, the assets that are indispensable for the execution of the sovereign's tasks remain entirely unaffected, and, on the other, that the responsibility of the Resolvency's success or failure rests completely on the parties involved. (...) In order to achieve this, the following three steps need to be taken: (1) A Resolvency Court would have to be set up (nature, structure, place and member selection mechanics); (2) rules determining the basic elements of the procedure and the functioning of the court would have to be designed by this Court and implemented; and (3) provide for the inclusion of a "Resolvency clause" in all credit related agreements and instruments so that all contractual claims against the sovereign are submitted to the Resolvency procedure and the Resolvency Court. (...) Concerning the Resolvency Court's location, (...)it would be preferable to have a special and independent chamber established at the European Court of Justice in Luxembourg'.

28 It has been noted, however, that 'a slow penetration of sovereign debt stocks with (single limb) CACs poses a threat on their effectiveness to enhance the resolution of sovereign debt crisis in the near future'.

eprs@ep.europa.eu (contact)

www.eprs.ep.parl.union.eu (intranet)

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