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Jeannette Abel

The Resolution of Sovereign Debt Crises

Instruments, Inefficiencies and Options for the Way Forward

Nomos

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Introduction

Almost every nation in the world failed to meet its obligations at some point.[1] Especially, European States have been serial defaulters in the past. Ironically, Greece claims the first recorded incident of sovereign default in 322 BC when ten Greek city-states ceased their payments to the Delos Temple.[2] Since its independence in 1800, Greece has spent more than half of the years in default.[3] In the 19th century alone, Greece defaulted four times on its external debts.[4] However, it is not Greece alone that obtained the status of a serial defaulter in the past. Between 1557 and 1788 Spain defaulted seven times[5] and France experienced eight defaults.[6] Prussia, Austria, Portugal and England also defaulted at that time.[7] Also in the 19th century, Austria, Portugal and Spain ceased their payments several times.[8] During the period of the Great Depression, almost all European countries defaulted on their war loans granted by the US.[9] Also Germany faced huge debt problems in the past mainly resulting from reparations to be paid for damages caused by Germany during World War I (WW I) and war debts accumulated during World War II

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1 *Neild*, 2388 years of unpaid government debt, global post, September 15, 2011; *Reinhart /Rogoff*, This time is different (2009), 86; *Szodruch*, Staateninsolvenz und private Gläubiger (2008), 71; *Wood*, State insolvency – what bondholders and other creditors should know , Allen & Overy Global Law Intelligence Unit (2010), 1.

2 *Neild*, 2388 years of unpaid government debt, global post, September 15, 2011; see also *Waibel* in *Kodek/Reinisch*, Staateninsolvenz, Vol. 2 (2012), 59; *Graeber*, Debt: The First 5000 Years (2012), 186 et. seqq.

3 *Reinhart/Rogoff,* This time is different (2009), 98.

4 For further details on Greece's defaults in the 19th century cf. *Waibel* in *Nierlich/ Schneider*, Conference Report: A Debt Restructuring Mechanism for European Sovereigns – Do We Need a Legal Procedure?, IILR 2012, 392, 421.

5 *Reinhart/Rogoff,* This time is different (2009), 86.

6 *Neild*, 2388 years of unpaid government debt, global post, September 15, 2011; *Reinhart/ Rogoff*, This time is different (2009), 86.

7 *Sturzenegger/Zettelmeyer*, Debt Defaults and Lessons from a Decade of Crises (2006), 4.

8 *Reinhart/Rogoff*, This time is different (2009), 92, 93.

9 *Waibel* in *Kodek/Reinisch*, Staateninsolvenz, Vol. 2 (2012), 62; *Tietje*, Die Argentinienkrise aus rechtlicher Sicht: Staatsanleihen und Staateninsolvenz, Beiträge zum Transnationalen Wirtschaftsrecht, No. 37, 6.

(WW II). It would probably still struggle to deal with this huge debt burden today, if it had not been relieved from the bulk of the debt by the London Debt Agreement that was reached in 1953.[10]

Although there have been lots of examples in history where States failed to meet their obligations, it was almost common sense that States are immune from default or as Walter Wriston in his position as former Citibank chairman between 1967 and 1984 famously put it "Countries don't go bust".[11] This belief is attributable to the fact that many States prevent themselves in self-made laws from insolvency (in Germany e.g. Sect. 12 (1) InsO). In addition, States are supposed to have unlimited financial resources because they are always able to implement new taxes or simply print new money. This might also be the reason why, there is no restructuring mechanism in place that deals with the restructuring of sovereign debts.

Another reason why there is probably no such mechanism in place, neither at international nor at European level, is the fact that over the last three decades sovereign debt crises only arouse in developing countries. Probably because of the common misconception that industrial nations may not experience situations of default nowadays, there were no rules or mechanisms implemented into the European Treaties that explicitly deal with this problem. The system of the Economic and Monetary Union, as we will see later,[12] mainly focusses on crisis prevention, rather than on crisis resolution. The expectations that sovereign debt crises nowadays only hit developing countries were belied however when the world financial crisis of 2008 hit Europe.[13] The European country that was first hit by the crisis was Iceland. After the crisis had seriously affected the banking sector of the country, Iceland nationalised three banks. Subsequently Iceland was not able to meet several bond obligations of those newly nationalised banks. Only the financial assistance of the IMF in the amount of $ 2.1 billion was able to prevent Iceland from

10 London Agreement on German External Debts, February 27, 1953, BGBl. II, 333; cf. also *Delaume*, Legal Aspects of International Lending and Economic Development Financing (1967), 53; *Waibel* in *Kodek/Reinisch*, Staateninsolvenz, Vol. 2 (2012), 65; *Waibel*, Sovereign Defaults before International Courts and Tribunals (2011), 148; *Ohler*, JZ 2005, 591; *Paulus*, IILR 2012, 6.

11 Cf. *Reinhart/Rogoff,* This time is different (2009), 51; *Wood*, State insolvency – what bondholders and other creditors should know, Allen & Overy Global Law Intelligence Unit (2010), 1.

12 See for more details Chapter 2 A.

13 *Caprio* et. al., Financial Crises: Lessons from the past, Preparation for the Future, 87 et. seqq.

a State bankruptcy.[14] When it became obvious by end 2009, that Greece would not be able to service its debts any longer, European politicians finally had to admit to themselves that sovereign debt crises may indeed be a problem of developed countries.[15] Generally, the European sovereign debt crises resulted from a lack of competitiveness and excessive government deficits.[16] Lacking competitiveness was especially a problem in Portugal, Spain and Greece.[17] Portugal and especially Greece showed more than excessive government deficits before the outbreak of the crises.[18] As the Eurozone members lost their ability to act to financial crises with monetary measures and as taxes cannot be raised indefinitely, they can only tackle these crises through the adoption of austerity measures. However, as austerity measures are hard to enforce, Member States tend to prefer to accumulate more debts in order to service their current obligations.[19] The contracting of borrowings seems like a win-win situation as politicians get the present benefits of being able to service their debts without burdening the citizens, thereby postponing the solution of problems to a later generation of political leaders.[20] This crisis resolution method was fostered by false market expectations: when the monetary union was founded, the markets failed to register any significant credit distinctions between euro area Member States.[21] The low

14 *Hummer*, Die Finanzkrise aus internationaler und österreichischer Sicht, 248; *Müller*, Können Staaten pleite gehen? (2011), 1.

15 *Pagenkopf*, NVWZ 2011, 1473.

16 Cf. e.g. *Burda* in *Nierlich/Schneider*, Conference Report: A Debt Restructuring Mechanism for European Sovereigns – Do We Need a Legal Procedure?, IILR 2012, 392, 400; *Mody*, Bruegel Working Paper 2013/05 (August 2013), 9 et. seq.; *Lipp* in *Paulus*, A Debt Restructuring Mechanism for Sovereigns – Do we need a legal procedure? (2014), 36.

17 *Gerken/Kullas/van Roosebeke*, Die EU Reform – Eine neue Ordnung für Europa, cepStudie (July 2013), 3 et. seqq.

18 *Gerken/Kullas/van Roosebeke*, Die EU Reform – Eine neue Ordnung für Europa, cepStudie (July 2013), 5; Allen & Overy, Global Law Intelligent Unit, How the Greek debt reorganization of 2012 changed the rules of sovereign insolvency, 6.

19 Cf. e.g. *Abele/Schäfer* in *Kodek/Reinisch*, Staateninsolvenz, Vol. 2 (2012), 279 et. seq.

20 *Paulus* in *Kodek/Reinisch*, Staateninsolvenz, Vol. 2 (2012), 12; *Paulus* in *Kadelbach*, Nach der Finanzkrise (2012), 113.

21 *Buchheit/Gulati*, Capital Markets Law Journal (2012), 7; *Abele/Schäfer* in *Kodek/Reinisch*, Staateninsolvenz, Vol. 2 (2012), 270; *Lipp* in *Paulus*, A Debt Restructuring Mechanism for Sovereigns – Do we need a legal procedure? (2014), 36.

interest rates encouraged States to accumulate debts worldwide and reduced the incentive to run sound budget policies.[22] Unfortunately, the asymmetrical structure of the monetary and budgetary sovereignty and the associated limited ability in the EU to enforce fiscal discipline contributed to the development of excessive government debt burdens in the euro area.[23] This problem is illustrated by the case of Greece. With entering the euro area, Greece gained the possibility to contract borrowings that would have been inconceivable before and borrow it did! Due to economic mismanagement and an unsustainably large debt burden Greece became the first country of the euro area to face a default. The debt crisis in Greece is thus considered as a budgetary crisis resulting from uncontrolled indebtedness.[24] Soon other Member States were facing huge financial problems as well. Among these Member States were Portugal, Ireland, Spain and Cyprus, which requested financial assistance in the course of the crisis. Ireland and Spain did not show excessive deficits prior to the crisis however.[25] Their crises were at least indirectly triggered by the world financial crisis, that itself resulted from the burst of the real estate bubble in the US.[26] With the introduction of the euro, financing conditions for private investors were extremely enhanced, which led to an "unsustainable expansion of private debt prior to the crisis"[27] and a real estate boom.[28] When the real estate bubble burst, many financial institutions were at the verge of bankruptcy.[29]

22 *Hofmann/Keller*, ZHR 175 (2011), 684, 686; *Abele/Schäfer* in *Kodek/Reinisch*, Staateninsolvenz, Vol. 2 (2012), 270.
23 Sachverständigenrat, Sondergutachten July 2015, 15; *Schuknecht* in *Paulus*, A Debt Restructuring Mechanism for Sovereigns – Do we need a legal procedure? (2014), 186.
24 *Hummer*, Die Finanzkrise aus deutscher und österreichischer Sicht, 250; cf. also *Gerken/Kullas/van Roosebeke*, Die EU Reform – Eine neue Ordnung für Europa, cepStudie (July 2013), 3 et. seqq; Allen & Overy, Global Law Intelligent Unit, How the Greek debt reorganization of 2012 changed the rules of sovereign insolvency, 6.
25 Sachverständigenrat, Sondergutachten July 2015, 14.
26 For further details cf. *Hellwig*, NJW 2010, 94 et. seqq.
27 *De Grauwe*, What kind of governance for the Eurozone?, CEPS Policy Brief No. 214 (September 2010), 7; *Mody*, Bruegel Working Paper 2013/05 (August 2013), 9 et. seq.
28 Sachverständigenrat, Sondergutachten July 2015, 14.
29 *Paulus* in *Paulus*, A Debt Restructuring Mechanism for Sovereigns – Do we need a legal procedure? (2014), 191; *Hummer*, Die Finanzkrise aus deutscher und österreichischer Sicht, 243 et. seqq; *Hofmann/Keller*, ZHR 175 (2011), 684, 686.

What originated as a banking crisis soon developed into a sovereign debt crisis in some euro area Member States as the financial institutions that were at the verge of bankruptcy were either bailed out or nationalised by those Member States.[30] Between October 2008 and October 2012 over 90 financial institutions within the European Union were supported by national governments.[31] Irish banks e.g. backed the wrong horse and lost billions when the real estate bubble burst and the world financial crisis hit them. Subsequently, Ireland either bailed them out or nationalised them, which eventually led to the sovereign debt crisis of Ireland.[32] The real estate bubble also hit Spain and its sovereign debt crisis almost exclusively resulted from the previous banking crisis.[33] The sovereign debt crises in Cyprus also essentially resulted from problems in the Cypriot banking sector, which was unsustainably large for the size of the Cypriot economy.[34]

To sum it up, now also and actually predominantly developed countries are facing sovereign defaults for the first time since WW II. However, not only European countries are at the verge of default, but also

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30 *Hummer*, Die Finanzkrise aus deutscher und österreichischer Sicht, 247 et. seqq.; *Gerken/Kullas/van Roosebeke*, Die EU Reform – Eine neue Ordnung für Europa, cepStudie (July 2013), 11; *Hofmann/Keller*, ZHR 175 (2011), 684, 686; cf. also *Mody*, Bruegel Working Paper 2013/05 (August 2013), 8; *Audit* in *Paulus*, A Debt Restructuring Mechanism for Sovereigns – Do we need a legal procedure? (2014), 213; *Paulus* in *Paulus*, A Debt Restructuring Mechanism for Sovereigns – Do we need a legal procedure? (2014), 191.

31 Commission Staff Working Paper, December 21, 2012, SEC (2012) 443 final, COM (2012) 778 final, 28, available at: http://ec.europa.eu/competition/state_aid/studies_reports/2012_autumn_working_paper_en.pdf.

32 *Hummer*, Die Finanzkrise aus deutscher und österreichischer Sicht, 251; *Gerken/Kullas/van Roosebeke*, Die EU Reform – Eine neue Ordnung für Europa, cepStudie (July 2013), 11; *Hofmann/Keller*, ZHR 175 (2011), 684, 686.

33 BBC News, Eurozone crisis explained, September 28, 2012; *Gerken/Kullas/van Roosebeke*, Die EU Reform – Eine neue Ordnung für Europa, cepStudie (July 2013), 11.

34 *Gerken/Kullas/van Roosebeke*, Die EU Reform – Eine neue Ordnung für Europa, cepStudie (July 2013), 11.

Japan[35] and even the US[36], have problems to service their sovereign debts.

Although, there is no restructuring mechanism for sovereign debts in place, crisis resolution is not completely disorderly. The international financial architecture provides some form of institutionalized crisis resolution for sovereign States (Chapter 1A), which is confronted with many inefficiencies however (Chapter 1 B). Presumably, at least partially due to those inefficiencies the euro area Member States opted for another crisis resolution approach, which will be presented in Chapter 2 B after the legal framework that creates the basis and marks the limits for crisis resolution within the EU has been described (Chapter 2A). As bankruptcy law eliminates most inefficiencies at domestic level, it shall be examined whether the crisis resolution approach in Europe involves any bankruptcy law elements and if so to what extent (Chapter 2 C). Subsequently it will be assessed whether the crisis resolution approach as a whole is able to eliminate the inefficiencies of the current international financial architecture (Chapter 2 D). Unfortunately, it will have to be concluded that the current crisis resolution approach in Europe is not even able to mitigate these inefficiencies and that it can therefore not be expected that it is sufficient to solve the current crisis in Europe. For this purpose alternative crisis resolution approaches shall be presented in Chapter 3 and assessed with regard to their ability to eliminate the inefficiencies of the current financial architecture. As it will turn out that only a restructuring mechanism seems likely to at least mitigate the aforementioned inefficiencies, guidelines for a European Crisis Resolution Framework will be presented in Chapter 4 B after discussing the objections against such a mechanism (Chapter 4 A). Finally, it will be shown how such a mechanism could be effectively implemented (Chapter 4 C) and a model law will be presented (Chapter 4 D).

In assessing the feasibility and adequacy of sovereign debt crisis resolution measures, economic consequences of these measures will have to

35 Cf. e.g. *Kono* in *Nierlich/Schneider*, Conference Report: A Debt Restructuring Mechanism for European Sovereigns – Do We Need a Legal Procedure?, IILR 2012, 392, 426; *Seith*, The Greece of Asia: Japan's Growing Sovereign Debt Time Bomb; spiegel.de; January 3, 2013, available at: http://www.spiegel.de/international/world/massive-japanese-sovereign-debt-could-become-global-problem-a-875641.html, last visited December 3, 2018.

36 Cf. e.g. *Watson*, US debt crisis: Congress passes deal, bbc.co.uk, October 17, 2013, available at: http://www.bbc.co.uk/news/world-us-canada-24559869, last visited December 2, 2018.

be presented and discussed due to the massive impact of sovereign debt crisis resolution on economic development. As this is a legal work, the treatises here neither raise claim to completeness of possible economic developments nor may these developments be permeated and captured as by an economist. In this context, it must be pointed out that not only primary sources have been cited in connection with economic issues.

Chapter 1: The current international financial architecture for sovereign debt crisis resolution

In case a company goes bankrupt, domestic or international bankruptcy law applies. For States, there is no such bankruptcy law, let alone any restructuring procedure.[37] Admittedly, the establishment of such a procedure was occasionally demanded throughout history.[38] A first attempt to establish such a system was already made as early as 1873 at the Public International Law Conference in Geneva.[39] Nonetheless, neither such a law system nor a sovereign debt restructuring mechanism has been established until today.[40] There is no stay on creditors, no formal priority ladder, no compulsory disclosure of the financial situation, no bankruptcy courts and no procedures.[41]

In the past simpler crisis resolution methods were preferred: French monarchs, for instance, simply used to execute their domestic creditors, wherefore the population started to refer to those habits as "bloodletting".[42] Such a resolution approach is thankfully not acceptable anymore, but other crisis resolution methods that were invented thousands of years ago, are still popular today. Such a method is currency debase-

37 *Waibel*, Sovereign Debt Restructuring, Seminar Internationales Wirtschaftsrecht, winter term 2003, University of Vienna, 6; *Wood*, State insolvency – what bondholders and other creditors should know , Allen & Overy Global Law Intelligence Unit (2010), 1.

38 *Szodruch*, Staateninsolvenz und private Gläubiger (2008), 38.

39 Cf. Second Annual Report of the Corporation of Foreign Bondholders for the Year 1874, available at: http://sul-derivatives.stanford.edu/derivative?CSNID=00002950&mediaType=application/pdf, last visited September 30, 2018, p. 73.

40 *Szodruch*, Staateninsolvenz und private Gläubiger (2008), 38; *v. Bogdany/ Goldmann*, ZaöRV 2013, 63; *Schwarcz*, Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach, Cornell Law Review, Vol. 85, 958.

41 *Waibel*, Sovereign Debt Restructuring, Seminar Internationales Wirtschaftsrecht, winter term 2003, University of Vienna ,6; *Wood*, State insolvency – what bondholders and other creditors should know , Allen & Overy Global Law Intelligence Unit (2010), 1.

42 *Reinhart/ Rogoff/ Savastano*, Debt Intolerance, Brookings Papers on Economic Activity 1 (Spring 2007): 1-74.