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Sovereign Bankruptcy in the European Union in the Comparative Perspective

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Abstract

This paper distinguishes four alternative sovereign debt resolution mechanisms: pure market solutions, modified market solutions, crisis lending by the IMF and other institutions, and the proposed Sovereign Debt Restructuring Mechanism (SDRM). It is hard to find—at the general level of analysis—the unique advantages of SDRM. The assessment of the European Stabilization Mechanism will ultimately depend on its operation, especially whether it will be a tool of subsidizing countries in debt distress or an instrument of fiscal crisis lending. The present fiscal problems in the eurozone are due to the erosion of fiscal discipline and not to the lack of strong compensatory transfers within the eurozone. The right model to look at the conditions for the stability of the eurozone is not a single state but the gold standard–type system, a system of sovereign states with a (de facto) single currency. Based on this analogy and considering modern developments, three types of measures are needed to safeguard the stability of the eurozone: (1) measures that would reduce the procyclicality of the macroeconomic policies and of the economy; (2) reforms that would help the eurozone economies grow out of increased public debt; and (3) steps to increase the flexibility of the economy so that it can deal with the future shocks in a better way.

JEL codes: F02, F00, F55, H6

Keywords: Debt Resolution, European Union, Eurozone, Financial Crisis, SDRM

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I. INTRODUCTION

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

II. TYPES OF DEBT DISTRESS

Various types of entities play the roles of debtors and creditors, which conclude the debt contract. Each of those units can run into debt distress, which I define broadly as any situation when the debtor has problems servicing the debt and/or paying back the capital according to the original schedule.

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

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

This distinction matters very much, especially in the case of debt distress faced by two types of debtors—the banks and the sovereigns—as the wrong diagnosis ex ante and the ensuing application of the wrong debt-resolution mechanisms may prolong the crisis instead of solving it. What I have especially in mind is misdiagnosing the liquidity problem while the true situation is insolvency. In the case of a bank, the resulting liquidity assistance from the central bank would delay the necessary restructuring of their balance sheets and thus prolong the accumulation of nonperforming loans, which culminates in a deep credit crunch, hurting the economy. This policy error is widely believed to have been committed in Japan in the 1990s. Some authors believe that it was also made in the United States during 2008–09 (Taylor 2009). The reverse error—confusing the liquidity shock with the insolvency situation of the banks—is probably less frequent (and perhaps less harmful) as the political and situational pressures are rather

focused on liquidity assistance. However, if committed it unnecessarily engages the administrative and financial resources of the intervening parties and is likely to lead to an increased moral hazard on the part of the debtors.[1]

Also in the case of sovereign debtors, it is not easy to make the ex ante distinction between the liquidity shock and the insolvency crisis. For definitions of both situations, see Roubini 2002 and Kumar, Masson, and Miller 2000.

What is usually meant by sovereign insolvency is the government's longer-term inability to service and/or pay back the debt. In other words "a country debt level is 'unsustainable' (Rajan 2005, p. 20), and thus some debt reduction or restructuring is necessary." However, it is difficult to distinguish a sovereign's inability to pay from its unwillingness to do so. Rajan (2005, p. 20) distinguishes between solvency shock and conditional solvency shock. In the former the level of debt is "simply unsustainable." In the latter "the country needs to undertake structural reforms to maintain solvency in the face of a shock, but would be solvent and would regain the confidence of international capital markets—conditional on undertaking those reforms." This implies that there are some hopeless cases where no reforms (and/or macroeconomic adjustments) can help a country regain solvency and other cases where there are some reforms and/or adjustments that, if implemented, would restore a country's solvency. It appears, however, that from the economic point of view there are almost always some packages of macroeconomic adjustment and structural reforms that, if launched and sustained, would make a country in debt distress capable of servicing and paying back the debt, i.e., avoiding the debt reduction.[2]

Therefore, from the purely economic point of view a country's inability to pay, i.e., its insolvency is an almost empty concept (Reinhart and Rogoff 2009). The empirically more relevant questions are: first, whether the package of adjustments—reforms that would restore a country's solvency if implemented—is *desirable;* and second, whether it is *possible* from the sociopolitical point of view to launch and sustain.

The desirability issue is about why the burden of macroeconomic adjustment,[3] necessary in the face of a large debt burden, must fall exclusively on the shoulders of the sovereign debtor (the same question is obviously true for other debtors, too). It is therefore about the "burden sharing" between the creditors and the debtor: A debt burden results from the decisions of both a debtor and its creditors and—so the story goes—both sides should be responsible for its resolution. And the evolution of the legal mechanisms

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

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

3. The controversy refers much more the issue of macroeconomic adjustment, which aims at reducing the domestic spending, than to the structural reforms that would enhance a country's long-run growth.

to deal with the debt distress of companies or individuals within the respective countries went from the exclusive responsibility of the debtor in the 19th century toward the shared responsibility of both sides: a debtor and its creditors. Regarding the sovereigns it is especially the odious debt, i.e., the debt inherited from the previous and oppressive regime that especially invokes the issue of the desirability of some debt reduction (Rogoff and Zettelmeyer 2002).

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

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

1. who is the sovereign, i.e., who are the relevant decision makers who represent the "sovereign;" and related to that
2. what are their utility functions (or—to put it simply—what do they care about), and what are the situational (including institutional) factors that determine their feasible set, i.e., the set of actions, perceived as feasible by the decision makers.

Based on that, one would know the relative expected utility of the options contained in the feasible set in the eyes of the relevant decision makers—in our case the utility of continuing to service and pay back the debt according to the original schedule relative to the utility of other options, seeking more or less voluntary debt restructuring or debt reduction, possibly coupled with some third party assistance or unilateral default. Such a model of the rational choice applied to a sovereign in debt distress must go well beyond the typical analytical treatment of a debt-distressed sovereign as one entity, usually a benevolent social planner bent on maximizing the social welfare in an infinite time horizon. In other words, the old-fashioned welfare economics perspective should be replaced by the public choice or—more broadly—the neoinstitutional economics approach where the decisions of the sovereign are explained by means of the general model, which includes the decision maker's choice situation and his or her cognitive and motivational characteristics (for more on this see Balcerowicz 1995). In trying to apply this model to the issue of the sovereign's willingness (or unwillingness) to pay, one must obviously consider the nature of the debtor countries' political regime. For example, in an entrenched dictatorship, a dictator who is a control freak and—as a result—is unwilling to enter any negotiations with the external creditors[4] will be willing to pay, i.e., willing to impose a very harsh adjustment program on his or her own people. An arch example is drastic adjustment imposed by Ceausescu on the Romanians in the 1980. Rulers in the fragile democracy, faced with the same serious debt distress, are likely to be less willing to pay, i.e., less willing to accept a harsh economic adjustment, which means that they would prefer other options: debt restructuring or debt reduction—possibly associated with some crisis lending. In other words, they would prefer protests from the financial markets to the protests from their own people.

However, things get more complicated if some of the residents are creditors to government. This brings me to the next issue. Not only does the nature of the political regime influence the sovereign's willingness to pay, but also the composition of the public debt. The financial liberalization of the last 20 years has blurred the traditional distinction between the domestic debt (i.e., denominated in domestic currency, based on the local law, sold to the residents) and foreign debt (foreign currency, foreign law, nonresidents). On the one hand, the residents hold nowadays some foreign currency, foreign law debt; on the other hand, nonresidents hold some local currency and local law debt securities (Gelpern and Setser 2004).

These developments have complicated the separation of the public debt from that owned by the nonresidents. However, the difficulty differs from case to case. The separation turned out to be possible in Russia after 1998 and in Argentina after 2001; in both these cases the domestic creditors, especially the

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

banks, obtained a better deal than the foreign ones. That separation was found too difficult in Turkey in 2001. As a result, the government chose the option of continuing to service the public debt owned by all the creditors (Gelpern and Setser 2004).

III. THE CAUSES AND COSTS OF THE SOVEREIGN DEBT CRISES

Serious sovereign debt crises stem from two major domestic sources:

1. the persistently and highly expansionary fiscal policy i.e., accumulation of budgetary deficits and—as the result—the increasing ratio of public debt to GDP; and
2. the banking crises, which sharply increase the public debt, both due to the costs of bailing out the banks and—even more—due to the recession that follows such crises (Reinhart and Rogoff 2009).

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

Serious sovereign debt crises and/or the related financial crises are socially costly because they lead to output losses—relative to a smoother trajectory of economic growth. Those losses are incurred during the recession that is brought about by the crisis. In addition, some crises may impair the longer forces of economic growth. This important issue is underresearched but the existing literature suggests that such a danger exists (e.g., Cerra, Panizza, and Saxena 2009). One of the possible channels is the political one: the public, inflamed by the media and the politicians, may blame the market forces for the crisis that in fact was caused by the public policy errors and the lack of structural reforms. If this is the case, than the resulting statist policies would weaken the forces of long-run growth (Balcerowicz 2010).

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

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

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

IV. DEBT RESOLUTION MECHANISMS

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

Sovereign debtors may have four kinds of creditors:

1. physical persons as holders of sovereign's bonds, both residents and nonresidents;
2. nonpublic organizations as holders of such bonds or providers of credit to the sovereigns (banks), both residents and nonresidents. Categories 1 and 2, taken together, make up the financial markets as creditors of the sovereigns;
3. other sovereigns (official lending), i.e., export guarantees or direct lending to other sovereigns; and
4. international public lenders of last resort (IMF, EU institutions with respect to the members of the European Union).

The behavior of sovereign creditors toward their sovereign borrowers in distress is unavoidably influenced by their foreign policy and geopolitical considerations (Sachs 2003). Paris Club, in existence since 1956, is the official forum for coordinating the policies of the sovereign creditors with respect to their sovereign borrowers that are in debt distress. I leave this issue aside, as official lending to the sovereigns has been declining in importance relative to the private creditors. Besides, it is the latter that is the focus of the discussions on the alternative debt resolution mechanisms, including the issue of the desirability, structure, and feasibility of sovereign bankruptcy. I should add, however, that with respect to countries with a high share of public debt it was the Paris Club that had played the leading role—both in the chronological and substantive sense—regarding the debt restructuring or debt reduction.[6]

6. For example in the case of Poland, which inherited from the socialist regime a heavy foreign debt burden, two-thirds of which was due to official creditors, the Paris Club decided in 1991 to grant Poland a debt reduction in the range of 50

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

1. *Pure market solutions*, also called by some authors "laissez-fair approaches" (Roubini 2002). They include unilateral defaults,[7] debt buybacks by the debtor on the debt market (Velasquez 1996), and more or less voluntary debt restructuring or reduction, based on the negotiations between the debtor and creditors.[8] Negotiations may, if successful, prevent the default or be conducted after this event.

2. *Modified market solutions*, called by some authors "contractual approaches" (Roubini 2002) or "orderly workouts without a bankruptcy court" (Rogoff and Zettelmeyer 2002 and Roubini and Setser 2004). They result from a sort of public-private partnership and have a form of debt contracts modifications, which aim at improving the coordination between the creditors in their dealings with the distressed sovereign debtor and thus at reducing the collective action problems among them. The main example of the modified market solutions are the collective action clauses (CACs) increasingly introduced into the bond contracts issued by the sovereigns since the early 2000s (IMF 2005). This tendency resulted from the interaction between the representations of the financial institutions and the governments of the major countries (Rogoff and Zettelmeyer 2002).

One could perhaps also classify the Brady Plan, applied in the 1990s, under the modified market solutions category. The difference relative to CACs is that more political pressure was probably applied in the case of the Brady Plan (Velasquez 1996) and that it was a one-time initiative while the CACs are meant—and likely—to be the permanent feature of the sovereign bond contracts.

3. *Crisis lending by the IMF (and some other institutions)*. Crisis lending has been conditional on the sovereign debtor's agreement to introduce policy changes that, if implemented, would hopefully remove the causes of the debt distress. The conditionality lending aims at dealing with the liquidity crises caused by creditors' panics, by external shocks, and/or by expansionary policies of the sovereign lender. The critics of the traditional IMF crises lending stress that in practice the IMF support amounted to the bailout of the creditors, thus increasing the moral hazard among them and burdening the debtor country with the excessive adjustment costs or that the content of conditionality was improper, or that the IMF

percent in net present value terms. It was followed in 1995 by a similar debt relief from the private banks represented by the London Club.

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

8. Trebesch (2009) proposes new empirical measure of cooperative versus conflictual crisis resolutions mechanisms.

has tolerated the nonfulfillment of its conditionality by repeatedly lending to the same countries (surveillance failures).[9]

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

Another response to the criticism has been opening the credit lines to those countries that are judged by the Fund to have been carrying out sufficiently sound policies.

This scheme of lending is thought to have better incentive properties than the traditional one as it depends on the past policies and not on the promised ones. However, the global financial crisis induced the vast expansion of the IMF's funds and a large increase in the scope of its traditional conditionality lending.

4. *Sovereign bankruptcy* (statuary approach), also known as a Sovereign Debt Restructuring Mechanism (SDRM). This is the debt resolution mechanism officially proposed by then Deputy IMF Managing Director Anne Krueger (2001), but—as distinct from the CACs—so far not implemented. At the general level it is meant to perform the same functions as the appropriate parts of the domestic bankruptcy laws that are applied to the firms. The essence of the bankruptcy law is that it provides a third party, a bankruptcy judge, or more broadly a referee, to which the creditors (or the debtor in distress) may legally turn.[10] The bankruptcy law also specifies what happens after the initiation of the bankruptcy procedure, including the scope and the mode of decision making by the bankruptcy judge. There are important differences in the national bankruptcy laws regarding the relative rights of the creditor and the debtor, the competences of the bankruptcy judge, the details of the bankruptcy procedure, etc. (For more on this see Pomerlano and Shaw 2005.)

As the focus of this paper is on sovereign bankruptcy I will concentrate my further remarks on the comparative analysis of SDRM. As distinct from the firms, (but similar to physical persons) sovereign states cannot be legally liquidated.[11] Therefore, out of the two parts of the domestic corporate bankruptcy: liquidation and reorganization, only the latter can-and does-serve as the model for the proposals for

9. There is a large literature on the IMF's conditionality lending. See, e.g., Lerrick and Meltzer (2001); Report of the International Financial Institutional Advisory Commission (2000); Dell'ariccia, Schnabel, and Zettelmeyer (2002); Jeanne and Zettelmeyer (2004); Roubini and Setser (2004); and Manasse and Roubini (2005).

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

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

sovereign bankruptcy. The reorganization provides the basis for the restructuring of a firm in debt distress as a going concern, performed under the supervision of the bankruptcy judge.

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

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

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

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

The main problem with these arguments is that they are rarely based on a careful comparative analysis of the proposed SDRM with the other already existing debt resolution mechanisms. This is, in turn, due to the fact that the SDRM could have many different versions, and the detailed differences in its structure could have large practical consequences (Bolton and Jeanne 2007). Comparing just the general

scheme of corporate bankruptcy with the more detailed and already existing models of alternative debt resolution mechanisms can lead to wrong conclusions.

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

1. *Ending, the creditors' flight* to the courthouse (a stay). Some authors stress that it is not an insurmountable problem under the pure market solutions by pointing to recent successful debt restructuring agreements (Vásquez 1996; Roubini 2002; Lerrick and Meltzer 2001; Schwartz 2003; and Panizza, Sturzenegger, and Zettelmeyer 2008). Besides, the widespread worries that the transition from bank-based sovereign debt to bond-based will magnify the collective action problems among the creditors have not materialized (Panizza, Sturzenegger, and Zettelmeyer 2008). Finally, the spreading CACs in the bond contracts may help to deal with this issue.

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

3. *The SDRM would replace the IMF's conditionality lending*. It is difficult to say ex ante whether the bankruptcy judges ordering a stay and mediating between the creditors and the sovereign debtor would be professionally better than the IMF staff at negotiating the conditionality with the sovereign debtor in distress and supervising its implementation.[12]

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

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

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12. According to some proposals it would be the IMF playing the role of a bankruptcy judge. This sidesteps the question of the comparative advantage of the new sovereign bankruptcy judges relative to the IMF. However it leaves the question why the new procedure would be burdened by fewer errors than that of the IMF's conditionality lending. Other proposals suggest that the courts would play a prominent role in the SDRM, which raises the issue of the potential conflicts between the IMF's decisions on crisis lending and the courts' decisions on sovereign bankruptcy. For more on this problem see Roubini and Setser 2004, pp. 249–334.

6. *Equal treatment of creditors of the same class*. It is hard to find evidence that an unequal treatment is a problem that has consistently plagued the decentralized negotiations between the sovereign debtor and its creditors. Furthermore, despite the avoidability of Chapter 11 corporate bankruptcy in the United States, the overwhelming majority of debt distress cases are carried out via out-of-court workouts. If this pure market–type debt resolution mechanism were burdened by the flagrantly unequal treatment of the creditors, the use of this mechanism would surely have been much more limited, and that of corporate bankruptcy correspondingly more popular. And with respect to the sovereign debt, the CACs are thought to provide a sufficient base for equal treatment.[13]

Summing up: It is hard to see, at the general level of analysis, the unique comparative advantage of the proposed sovereign bankruptcy. Other already existing debt resolution mechanisms may deliver the same *types of* outcomes, which means that—at this level of analysis—they are functionally equivalent to sovereign bankruptcy. This points to more general lessons for the analysis of different institutional arrangements: One should avoid being fixated on the names of the analyzed arrangements or on their legal particularities. Instead one should focus on the outcomes produced by—nominally and legally different—institutional schemes and inquire whether *and to what extent they are functionally equivalent*. As a matter of fact, the macroeconomic adjustment and structural reforms carried out under the supervision of the IMF within the framework of its conditional lending appear to come close to the general model of organization under the bankruptcy law. In this sense the sovereign bankruptcy regime—in the functional sense as distinct from the legal particularities—already exists. However, it is not what the proponents of SDRM have in mind even though—according to some proposals—the IMF would play an important role in the sovereign bankruptcy regime (Bolton 2003 and Buckley 2009).

The question to be investigated is therefore whether the legal possibilities and incentives to the relevant actors provided by legally different arrangements are such that they produce similar (or different) solutions to a given problem. And this appears to be the case with sovereign bankruptcy compared to other sovereign debt resolution mechanisms. This conclusion holds for the general level of analysis. A different conclusion might be reached if the proposed sovereign bankruptcy schemes were sufficiently specified to allow for the quantitative assessment of the different outcomes under the various options of the SDRM and the already existing (or proposed) mechanisms. I was not able to find in the relevant literature a comparative analysis of detailed SDRM schemes with the similar versions of the other arrangements for the sovereign debt resolution, so I have to stop at the general conclusion. Let me add,

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

however, that some authors stress that the devil indeed lies in the details and they warn against the negative and unintended consequences of badly structured SDRM (Bolton and Jeanne 2007).[14]

So far I have been dealing with the *ex post analysis* of the alternative sovereign debt resolution mechanisms i.e., of how they cope with the debt distress, which is already present. However, there are some important questions belonging to the *ex ante analysis* of these mechanisms, namely: How do they structure the incentives and—thus—the behavior of the sovereign debtor and its creditors before the potential debt distress crises—in other words—what are their relative strengths and weaknesses in contributing to the occurrence of serious debt crises (and other problems) in the first place? As I have already emphasized, this is an important criterion, as such crises are socially costly.

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

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

There are serious indications that the financial markets behave in a procyclical way:[15] lending too much during the booms and thus amplifying them and then sharply curtailing their loans, thus contributing to the bust. In addition, because of political economy factors, governments' fiscal policies are often procyclical, too. In such a situation, a debtor-friendly SDRM would make the financial

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14. Another objection to the SDRM is that while it would produce broadly similar effects to other debt resolution mechanisms, its introduction would require much more political effort on the international scale (Roubini and Setser 2004, pp. 332–334).

15. This tendency for procyclical behavior of financial markets may be strengthened by the procyclical monetary policy, (as it appears to be the case before the present global financial crisis, especially in the case of the US Fed) and other political interventions. For more on this see Calomiris 2009.

markets more vigilant in the earlier stages of lending to the sovereign borrowers and, therefore, could strengthen their early warning function, thus possibly making the governments more prudent. This, obviously, assumes that the sovereign debt crises arise mostly because of the insufficient early warnings to the governments and not due to the institutional (or personality) factors that make them ignore such warnings. However, there is evidence to the contrary, including fiscal policies in Ireland, Britain, the United States, Hungary, etc., before the recent crisis. Hence, to be fully effective the strengthened early warnings systems would have to be accompanied by the changes that would make the governments more sensitive to them. These changes include the institutional reforms that would constrain the growth of the public spending and/or of budget deficits and/or of the public debt. Ultimately, however, it is a strong representation of fiscally conservative voters, which is needed—in democracy—to make the governments pay more attention to signs of the incoming debt distress.

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

My comment on this position is that it assumes that governments are price sensitive in their borrowing activity. However, at least some of them are not and then the introduction of SDRM would—in the worst case—make the sovereign borrowing more expensive without reducing the danger of the sovereign debt crises. It appears again that there are no good substitutes for measures that would make the policy frameworks and societies fiscally more conservative. If this is the case more vigilance from the financial markets should be welcomed.

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

evolution should and—hopefully—would be present in the case of sovereign bankruptcy (e.g., Sachs 2003 and Buckley 2009).

However, reasoning by analogy is risky because analogies often happen to be very imperfect, and this is surely the case with the analogy I have just mentioned. In the case of individuals and firms, the starting point was that in the case of insolvency they would completely lose their sovereignty as their creditors enjoyed absolute legal rights. The evolution of domestic bankruptcy law has granted the borrowers some sovereignty in the situations of the debt distress. This is understandable from the moral point of view and—up to a point—might have been economically beneficial if the increased moral hazard on the part of the borrower has been more than compensated by their increased readiness to engage in socially useful but inherently risky innovations. However, in the case of the sovereign debtors there was never a time during the debt distress when their sovereignty could be legally eliminated, and this has been certainly the situation in the 20th century and later. Indeed, one of the main problems discussed in the literature on sovereign debt is why the sovereigns being sovereign, i.e., not subject of the legal disciplines applied to the individuals and firms during the debt distress, are able to borrow at all (on this vast subject see Rogoff and Zettelmeyer 2002 and Panizza, Sturzenegger, and Zettelmeyer 2008). The evolution of domestic bankruptcy law has been from no sovereignty for the borrowers during the debt distress to some balance of rights between them and their creditors. No necessity ever existed for such an evolution for the sovereign debtors as they have enjoyed sovereignty all the time. The analogy to the evolution of corporate and personal bankruptcy law is, therefore, misleading and cannot substitute for the comparative analysis of the proposed sovereign bankruptcy law and the other already existing mechanisms of the sovereign debt resolution. (For other objections to this analogy see Roubini and Setser 2004, pp. 293–306).

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

borrowing themselves are not enough to contain a dangerous accumulation of the public debt. In addition, one needs an increased sensitivity of the sovereigns to those signals and to the increased cost of borrowing.

In conclusion, while it might have been true that sovereign bankruptcy was not introduced because of the great political complications and the resistance of the private creditors (Sachs 2003),[16] it is far from certain that it deserved to be introduced.

V. THE PROBLEM OF SOVEREIGN DEBT IN THE EUROPEAN UNION

Dramatic fiscal developments in Greece have provoked a huge and ongoing debate about how to deal with Greece's predicaments and eurozone problems. The discussions—and some decisions—have dealt with three overlapping problems:

- the actual crisis management in the European Union with the Greece's debt distress;
- debt resolution mechanisms in the eurozone; and
- longer-term solutions for the eurozone or—more broadly—for the European Union.[17]

Let me start with the issue of "contagion." Some of the countries outside the eurozone—Britain, Hungary, the Baltics—have been undergoing a very serious worsening of their public finances. This, however, has not been widely perceived as the European Union–wide problem. In contrast, the dramatic fiscal developments in Greece have been widely commented as the eurozone problem. A reason for that appears to be the perceived danger of "contagion" in the eurozone, which would erupt if Greece defaulted. There was not much mention of "contagion" with respect to the European Union in the debate on Britain's or Hungary's fiscal problems. It is evidently assumed that if Greece defaulted, the negative spillovers *to other members of the eurozone* via the negative reactions of the financial markets could be especially serious. (More orderly debt restructuring was not considered). What is the basis for such a claim? Is it the fact that countries share the same currency, or the fact that some other members of the eurozone, especially the large ones (Spain and Italy) are regarded by some as having a bad fiscal situation (a large budget deficit in the former, a huge public debt in the latter)? If the first factors were the main reason, the fiscal problems of Ecuador (dollarized) or of Rhode Island (a small state in the United States) would produce a threat to the dollar. But such an assertion is absurd. Therefore, it is not so much the

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

17. I will leave aside here the proposals for how to deal with Greece's problem of insufficient external price competitiveness—the result of years of excessive growth of consumption, both public and private. They envisage Greece temporarily leaving the eurozone and then reentering it at a more competitive exchange rate (Feldstein, 2010), the temporary introduction of dual currency in Greece (Goodhart and Tsomocos 2010), or the radical reform that would lower the labor taxes at the expense of increasing the value-added tax (VAT), etc.

strong linkages generated by the monetary union per se, but the fact that some of the large members of the eurozone may be perceived by the financial markets as fiscally vulnerable that has been behind the fear of "contagion." Therefore the solution to this problem is not only the rapid fiscal consolidation in Greece but visible fiscal improvements in Spain and Italy.[18] This suggests that, while the eurozone has the uniform fiscal rules (see later), their enforcement should be especially stringent with respect to the larger members. However, the practice has been the opposite.

Among the EU members outside the eurozone, Hungary and Latvia turned to the IMF for the conditional crisis loans and obtained them. There was, to my knowledge, not much controversy about it in the EU decision-making bodies. In contrast, Greece's use of the IMF crisis lending has been subjected to heated debates in these institutions and was admitted after much delay. It is hard to see the economic rationale for such double standards. If Hungary and Latvia were regarded to be in need for some conditional crisis lending, then this is no less true of Greece, too.[19] The European Union and the eurozone did not have at their disposal any ready-to-use institutional mechanisms of crisis lending that would have the resources and the technical competence of the IMF (Pisani-Ferry and Sapir 2010). One must ask the question whether the opposition to Greece going to the IMF stemmed from the belief that no member of the eurozone should ever use the crisis lending as such or that no eurozone member should ever use IMF assistance. Both assumptions are difficult to defend on rational grounds. Therefore one is left with the supposition that those who opposed the IMF option for Greece either erred in their economic reasoning or were guided by some prestige considerations that they do not clearly spell out.

After much delay and under the pressure of the financial markets, dramatic steps were taken on May 7, 2010, by the EU decision-making bodies: the establishment of the European Stabilization Mechanism (ESM)—to be discussed in a while—and the European Central Bank's (ECB) decision to engage in outright purchases of government debt or, to be more specific, Greek debt. The latter step was widely—and I think rightly—perceived as a huge shock to the ECB's reputation. It was noted that "it is clearly inappropriate for any central bank to provide ongoing monetary financing for a sovereign that is no longer able to fund itself in the capital markets due to concerns about its solvency" (Mackie 2010, p. 2). The ECB's explanation that buying the Greek bonds was necessary to reestablish a "more normal" functioning monetary policy transmission mechanism is not very convincing as it begged the question: What price levels of bonds issued by eurozone countries are compatible with the "normal" operation at this mechanism? The future will tell whether and how the ECB will restore its credibility.

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

19. It is worth noting that some EU countries that face a very serious economic and fiscal crisis—Estonia, Lithuania, and Ireland—are coping with its consequences via tough economic adjustments and without IMF assistance.

It is difficult to assess the consequences of the EU interventions as the alternative options for how to deal with Greece's fiscal crisis were not spelled out and thus a necessary comparison was not made.[20] The alternatives were rather presented as an unmitigated catastrophe that likened framing the alternatives to bailing out the large financial conglomerates or to a discretionary fiscal stimulus. However, even the proponents of the EU interventions admit that—in themselves—they did not provide a lasting solution but serve to buy time. The question is: buying time for what? This brings me to the next two issues.

Let us start with the debt resolution mechanisms. Section 4 presented four categories of such mechanisms with a focus on the comparative analysis of the Sovereign Bankruptcy (SDRM). I think that the conclusion of this section holds also for the eurozone:

- There exist pure market solutions and modified market solutions that are available for the euro area countries, too. I don't see any reason why these countries should be banned from using them.
- The proposed SDRM does not offer any comparative advantage over other mechanisms (at least at the general level of analysis), and it is politically very difficult to introduce. It is hard to think of any eurozone's specificity that would justify its introduction in this area.

What about the euro-specific crisis lending facility in the form of the ESM? It consists of a €60 billion rapid reaction stabilization fund, controlled by the European Commission, and "a special purpose vehicle" created by an intergovernmental agreement among eurozone members that will raise up to €440 billion for the market. The former component is guaranteed by the EU budget, i.e., ultimately by the EU members, the latter by the participating countries in proportion to the national shares in the ECB's paid-in capital.

One should not disregard the fact that the creation and use of the ESM required a rather heroic interpretation of Article 122.2 of the European Treaties, which "requires there to be exceptional occurrences beyond a member state's control for aid to be justified" (Buiter 2010, p. 6). This step might contribute to the perception that the European Union, while praising the rule of law, is not in fact a rule of law community because it violates its own treaties.

However, it will be the operation of the ESM that will ultimately decide how it is going to be assessed. At the moment I can only ask some questions. First, the ESM's lending is to be conditional on a borrower-country's promised program. What will be the relationship between this conditionality and that of IMF? And a more general one: What is the intended relationship between the activities of these two institutions?

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20. Some authors (e.g., Gros 2010, Dizard 2010, Roubini 2010, Subramanian 2010, Weinberg 2010) argued that a better option would be the restructuring of Greece's debt, and that the EU interventions have only delayed this necessary step.

Second, as the ultimate fiscal responsibility for the operation of the ESM falls on the shoulders of the taxpayers in the participating countries, the final judgment of the ultimate authority—that of the citizens, especially in net payer countries—would depend on whether they will actually have to finance the losses of the EMS, i.e., whether its conditional lending will turn into subsidizing the less disciplined eurozone countries. This depends on the quality of the ESM's operation and how it would affect the policies of the recipient countries. In discussing these issues one can draw on a huge literature on the IMF (see footnote 9).

Finally, let me turn to the issue of long-term solutions for the eurozone. The creation of the eurozone is widely thought to be an experiment: It is the monetary union without the political union and is claimed to be distinct from previous monetary unions, which were combined with the political unions. This assertion is not very convincing. The countries that adopted the gold standard in the second half of the 19th century created a monetary union—in a broader sense—without the political one. To some extent the Bretton Woods system constituted a monetary union in the sense that its fixed-peg principle sharply limited the room for independent monetary policy for the members of this system. However, they clearly did not form the political union. Therefore, instead of focusing on the "political union" as the requirement for the well-functioning monetary union, it is better to inquire as to what is the broader set of conditions that determine the performance of any international monetary system based on hard pegs between the member countries' currencies.

First, they all required fiscal discipline from their members. This had been the case under the gold standard with its informal norm of a balanced budget until both the norm and the gold standard unraveled under the shocks of the First World War and then the Great Depression. Both the norm of the balanced budget and the gold standard were later delegitimized among the elites because of the expansion of Keynesianism.

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

The meaning of the term "political union" in the debate on the eurozone is often vague. My view is that in the context of the monetary union debate, the political union should be defined as having at least two components:

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

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

Condition 1 constitutes the preventive arm of the political union, i.e., it aims at forestalling the fiscal threats to the value of the common currency.[21] Condition 2 is the shielding arm of the political union i.e., it is designed to protect the population of the most affected regions from the deep declines in consumption. I have the impression that those who claim that "political union" is necessary (or at least desirable) for the monetary union have mostly in mind condition 2 and disregard condition 1, despite the fact that fiscal constraints on the local governments are clearly a typical and important component of the single sovereign states, the strongest form of the political union. In this sense they ignore the fact that Stability and Growth Pact has been, in principle, an important *component* of the political union and not its *substitute* (for the importance of this pact see Tanzi 2004).

It is useful to look against this background at the creation and the evolution of the eurozone. To cut a long story short: Fiscal criteria (Stability and Growth Pact) were rightly introduced, as they constitute an important preventive arm of the political union that is important for the monetary union. In addition, at the insistence of Germany, the bailout clause was introduced in order, I think, to strengthen to incentives for fiscal discipline in the respective members of the eurozone and to avoid any Argentinean-type developments whereby the fiscal irresponsibility of the provinces undermined the fiscal and monetary stance of the whole union. However, from the very beginning these safeguards have been eroded by the largest countries in the eurozone (Germany and France), which obviously have had the crucial weight in decisions regarding the creation and evolution of the eurozone.

First, the original sin was committed: countries that were in violation of the fiscal criteria (Italy, Belgium, and probably Greece) were admitted into the eurozone. Second, Germany and France breached the Stability and Growth Pact. Third, in response to that, the pact itself was modified, i.e., it was made more flexible. Many economists criticized what they perceived to be the macroeconomic imperfections of the pact and welcomed its modifications. However, I think they missed the essential point: rules that are violated and then quickly modified by the largest members of the club stop being the rules at all, i.e., they cease to be binding constraints for members of the club. I don't want to say that external pressure is sufficient to make the members respect the agreed norms of fiscal discipline. On the contrary, there is no good substitute for domestic frameworks for the fiscal behavior of governments and—what ultimately matters—for the strong representation of the fiscally conservative voters in the respective countries.

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

However, the violation and then modification of the agreed common norms of the fiscal conduct created a sort of bad demonstration effect and thus made the emergence of such domestic frameworks and of the appropriate structure of the public opinion much more difficult.

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

However, just deploring the past errors is not a proper way of dealing with their consequences. What one needs instead is to learn from these errors.

It should be amply clear that there is no scope in the foreseeable future for the extension of the EU budget so as to strengthen the shielding arm of the political union via increased fiscal transfers to the members affected by deep declines in consumption. An increased role of such a budget requires an enhanced level of group identity that cannot be artificially generated by the political elites. And the European Union, given the separate histories of its member states, is certainly a long way from a strong European identity among the respective societies. What is more, as rightly stressed by Otmar Issing (2010), any attempt by the elites to engineer bailouts of the members that are in a clear breach of the commonly agreed rules would provoke a storm in at least some countries thus depressing—and not enhancing—the level of "European solidarity."[22]

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

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

One may group these conditions into three categories:

1. *The mechanisms to prevent the procyclical policies and large fiscal shocks*. These mechanisms should operate both at the level of the European Union (and at the eurozone) and at the level of the respective countries.

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

2. *Structural reforms that would strengthen their long-run growth*. They are not only necessary for the continued improvement of the standard of living of the populations but also to help them to grow out of the increased public debt (White 2010).
3. *Structural reforms to facilitate the adjustment of the economy to various shocks.*

In the first category the following measures appear to me to be most important:

- *The accounting rules*, which define the budgetary deficits and the public debt, must be made credible and transparent. Enron-type accounting should have no place either with respect to companies or governments. The rules should consider not only the explicit debt but the implicit debt, too (e.g., the pension liabilities).
- *The monitoring* of the budget deficits and of the public debt must be strengthened. This is the job for the Eurostat, the European Commission, and for the European Risk Council. The monitoring should also focus on the development of the asset bubbles that, when burst, may produce deep recessions and the resulting sharp increases in the budgetary deficits.
- *The Stability and Growth Pact* should be enforced, which implies the use of available sanctions that should be strengthened, if possible.
- *The monetary policy of the ECB* should pay more attention to the developments of asset bubbles, which, when burst, can produce huge fiscal shocks. In other words: It should be more conservative than the policy that is only guided by the inflation measured only by the consumer price index. It could mean that the ECB makes more use of its monetary pillar in its decisions on the interest rates.[23]
- The ECB's common monetary policy cannot fit the macroeconomic conditions of all the member countries. For example, the ECB's interest rates were too low for Spain or Ireland which contributed to the developments of asset bubbles in these economies with the resulting bust, recession, and large increase in their public debts. Therefore, the eurozone countries (and other countries, too) need an additional instrument: *macroprudential regulations,* which aim at reducing the excessive growth of credit. While the need for such regulation is nowadays widely recognized, much technical work remains to be done.
- The initiatives at the EU and/or eurozone level cannot substitute for the strengthening of the preventive mechanisms in the respective countries, which is ultimately the responsibility of the domestic politicians and the public at large. However, the disciplining measures at the EU level are desirable or perhaps even necessary to spur the growth of the preventive mechanisms in their

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

respective countries. As the EU initiatives are largely dependent on large countries, they bear a special responsibility for the developments in the eurozone and in the European Union.

The second category would include the following main steps:

- At the EU level, probably the most important mechanism for longer-term growth of *all* the member states is *the single market.* Therefore, economic nationalism that risks damaging it must be prevented at all costs. This is necessary but not sufficient. The vigorous effort to complete the single market should be relaunched. This applies, first of all, to nonfinancial services, where there is the largest gap vis-à-vis the United States.
- *The Lisbon agenda* should focus on economic goals and be reinvigorated. This should mean more market reforms and not setting the numerical measures, which make little sense, e.g., requiring that all countries spend 3 percent of their GDP on R&D.[24]
- The EU institutions and countries should reconsider measures that risk imposing additional burdens on the economies and/or hamper the flexibility of markets. I have in mind, first of all, *the European Union's climate policy,* which has had a weak analytical basis and has been presented as though it was offering a free lunch. The drift toward *the social policy* increasingly becoming the European Union's responsibility should be stopped, as it risks introducing additional rigidities and burdens in the more flexible economies and raises fundamental constitutional questions (the subsidiarity principles).[25]
- *The fiscal reforms* in the respective EU countries are not only fundamentally important for the short run, i.e., to deal with the increased budgetary deficits and the public debts, but from the longer run, too. Persistent deficits and a large public debt are detrimental to the longer-term growth, because sooner or later they crowd out private investment and introduce harmful uncertainty, which worsens the investment climate. *The mode* of fiscal consolidation also affects the forces of growth: As all EU members have an already large tax burden, further tax increases would weaken those forces. The focus of fiscal reform should thus be put on measures that reduce the growth of spending commitments, which—given the aging of the EU societies—must include the pension reforms that raise the age of retirement.

Finally, regarding the third category let me note that some investigations suggest that fiscal adjustments in the absence of the depreciation option, i.e., under hard pegs, may be more difficult than those when depreciation or devaluation options exist (Lambertini and Tavares 2005 and Mati and

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24. This target disregards the differences in the level of development: Economies with larger per capita income can use more technology transfer and thus need to spend less on R&D. Besides the increased R&D should result from the reforms that increase the scope of markets and the intensity of competition.

25. For more on that see Klecha 2008 and Threlfall 2007.

Thornton 2008). However, this is obviously not a reason to scrap the European Monetary Union, but an argument for the measures to prevent the serious fiscal imbalances in the first place (category 1). It also increases the importance of structural reforms that would facilitate the adjustment of the economy to various shocks, including the fiscal consolidation. *Rigid (or dual) labor markets and—more generally— rigid prices* and regulatory constraints on the supply response of the economy deepen its recessionary reaction to various shocks and contribute the growth of unemployment. Therefore, the liberalizing reforms should be a priority wherever needed, and should be the other focus of the reinvigorated Lisbon Agenda.

No amount of exclamations about "European solidarity," "social cohesion," and the "European social model" can substitute for these reforms, especially—as I already stressed—the European Union–wide shielding fiscal policy, which is not a prospect and even if it were it would not provide the proper response to the main problem: the weakness of the preventive mechanisms in the European Union.

VI. CONCLUDING COMMENTS

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

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

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

The SDRM may also change the behavior of sovereign debtors and their creditors thus raising some important questions of ex ante analysis. The financial markets may become more vigilant and charge more

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

Turning to the European Union it is hard to understand on economic grounds why there was not much discussion in the European Union before Hungary and Latvia, which do not belong to the eurozone, turned to the IMF for conditional assistance, while there has been huge resistance against Greece doing the same. The dramatic decisions taken by the EU decision-making bodies on May 7, 2010, especially the ECB's decision to engage in buying the distressed debt Greece, carry heavy reputational costs. It is difficult to assess them more fully as other options of the crisis management (e.g., Greece's debt restructuring) were not spelled out. However, even the proponents of these interventions admit that they do not constitute lasting solutions but serve to buy time.

The creation of the European Stabilization Mechanism required a rather heroic interpretation of the Article 122.2 on the European Treaties. The assessment of this mechanism would ultimately depend on its operation, e.g., its relationship to the IMF and especially whether it will be a tool for subsidizing countries in debt distress or an instrument of crisis lending.

The creation of the eurozone is often regarded as an experiment because—the story goes—it meant the creation of a monetary union without a political one. However, the proponents of this view seem to equate the political union with the model of a single sovereign state and especially deplore the lack of large fiscal compensatory mechanisms in the present eurozone. I suggest that they used the wrong model. First, they disregarded the importance of fiscal constraints imposed upon the local and regional governments in the single states. In this sense, the Stability and Growth Pact has been, in principle, an important preventive part of the "political union" and not the substitute for such a union. Second, the present fiscal problems in the eurozone are due to the erosion of the fiscal discipline in the eurozone, partly due to the disregard and then modification of the Stability and Growth Pact—and not to the lack of a strong compensatory transfer within the eurozone. Third, the right model to look at conditions for the stability of the eurozone is not a single state but the gold standard–type system, a system of sovereign states with (de facto) single currencies. Based on this analogy and considering modern developments, I list the conditions that I consider essential for the stability of the eurozone. I divide them into three groups: (1) measures that would reduce the procyclicality of the macroeconomic policies and of the

economy; (2) reforms that would help the eurozone economies grow out of the increased public debt; and (3) steps that would increase the flexibility of the economy so that it can to deal with the future shocks in a better way. All of these reforms are, of course, also needed in the EU countries that do not belong to the eurozone.

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