Better options, specifically for the Euro

Unsustainable sovereign debt was the flashpoint of the Euro Area crisis. Prior to OMT, fear of default caused investors to flee peripheral sovereigns giving rise to concerns that the Euro might disintegrate.

In that context, the IMF faced a dilemma. Its lending rules, dating from 2002, only allowed it to lend large amounts to countries with debt which was sustainable "with a high probability." Otherwise, restructuring to secure sustainability was required. Although Greece in 2010 failed this test, a write down then (pre-OMT) would have jeopardized confidence in many other Euro Area sovereigns. So the "cure" of Greek debt restructuring might have been worse than the disease. In that light, the IMF changed its rules in 2010 to allow it to lend large amounts, despite failure to meet the sustainability criteria, if systemic concerns were present.

It was no solution. The euro crisis deteriorated and private creditors exited Greece en masse, financed by official credit, including the IMF. Even the IMF staff now opine here that "since contagion is exacerbated by uncertainty, a large scale bail-out that fails to address underlying concerns regarding sustainability will not mitigate contagion risks", albeit suggesting, somewhat improbably, that this is only evident from "experience." And while OMT has eased immediate market concerns, it has done so by a conditional promise of liquidity; the adverse "R minus G" algebra and with it, Euro sovereign insolvency in a number of cases, remains at issue.

The overriding objective of the IMF debt restructuring proposals here is to avoid a repeat of circumstances where it ends up financing private creditor exit from a country with doubtful solvency. So the IMF defines the problem that way, rather than in terms of how to prevent global crisis. And the solution proposed is nested within the IMF's long tradition of "universal" solutions to these problems, the most recent prominent example of that was the 2001-02 SRDM proposal, and nested in the consequent decision to manage sovereign insolvency via voluntary adoption of collective action clauses (CACs).

But the narrow focus on preventing IMF financing for creditor exit combined with the premium on universality and reliance on CACs leads to failure to prioritize the more urgent issue from the viewpoint of preventing global crisis—which is how to anticipate renewed Euro Area crisis.

The urgency of that issue reflects that underlying sovereign insolvency in the Euro Area remains in doubt, not just in small cases such as Greece, but in Italy and Spain, and possibly even France. This reflects not only the general poor growth outlook, but also further need for relative prices to fall in fragile Euro Area countries.

And in light of the evident insufficiency of the CAC framework to deal with the Euro Area insolvency issues which erupted in 2010, the Euro Area, by continuing to rely on CACs—even progressively enhanced from 2013 by aggregation clauses in new issues—still lacks a sufficient framework for orderly write-down of outstanding sovereign debt as may ultimately be needed. Yet, as the IMF might (should?) put it, "experience shows" that disorderly resolution of such matters could pose a major threat to the integrity of the Euro, a risk which the "whatever it takes" ECB commitment cannot resolve.

Indeed, by posing the issues in the self-focussed and universalist way it does rather than focussing on the remaining insolvency threats in the Euro Area, the IMF proposals aggravate the problems in the Euro Area.

In particular, the staff now propose a "presumed maturity extension" by all creditors in high access IMF lending cases where the solvency of the sovereign is unclear. Private creditors would voluntarily commit to maintain their exposures until it becomes clear if the policies implemented under IMF-auspices succeed in securing better economic prospects for the country concerned.

Strictly speaking, this "proposal" describes the status quo—as creditors can already extend maturities if they so choose. The fact that they choose not do so indicates that the IMF proposal goes against the grain. Thus, the (unstated) novelty in the IMF

proposal is that creditor assent to maturity extension would be effected through official "suasion".

Accordingly, if the proposal goes into effect, creditors will anticipate "risk of suasion", rendering them liable to abandon exposures at an earlier stage in order to evade it. In this way, were the IMF proposals to proceed in the Euro Area, they may not only fail to "mitigate contagion risks" there, but may aggravate them by compounding incentives for preemptive investor flight in times of stress.

The staff approach has three other shortcomings in the Euro Area:

- CACs in the Euro Area leave the process of sovereign insolvency to the sovereign and its creditors, ignoring that how these interactions in one Euro country intimately affects others—and that in turn affects the ex ante and ex post behavior of the individual Euro sovereigns and their creditors.

- The approach overlooks the opportunity to address these interactions between Euro sovereigns within the policy coordinating structures in the Euro area that not only already exist, but which are anticipated in the commitment to "ever closer union" that Euro Area members formally make.

- And the approach provides no incentive for new private credit in the interim. If new credit is extended in such an interim and the sovereign turns out to be insolvent, those new creditors will participate in the write-down along with others. So new money is likely to stay out, just in case, and so the full burden of financing for troubled sovereigns in the interim rests on public creditors, including the IMF.

Such shortcomings have not and will not completely prevent debt write downs even in the Euro area. But such events, as in Greece in 2012, and the proposed associated maturity extensions will only occur via fierce coercion of creditors by their home authorities—including their financial regulators—to assent. Such coercion has many downsides, including tardiness, unequal treatment, and opacity. And it went as far in Greece—in respect of bonds issues under local law—as removal of creditor veto

rights by retroactively changing the law, a step which may yet prove inconsistent with the European Convention on Human Rights. Given these evident downsides, it is remarkable that the latest IMF proposals essentially continue reliance on such official "suasion".

More sanguine commentary is not unduly perturbed by all of this, arguing that remaining Euro insolvency risks are low "so long as everyone pulls their weight and there are no more mistakes", and that effort to make proper insolvency arrangements for them could distract from effort to avoid insolvency and might unsettle markets again. But this ignores the remarkable propensity to mistakes in the Euro Area and the inherent design flaws in it which give rise to negotiating gridlock and powerful free riding incentives for Euro members not to pull their weight. And it is akin to arguing against additional life boats for the Titanic because the added weight would slow the ship down and spook passengers when the twain were unlikely to converge anyway—so long as everyone pulls their weight and makes no more mistakes.

So the IMF staff is right to keep working on issues of sovereign insolvency. But given the urgency and centrality of the issue, it is truly remarkable that though the IMF has opined on virtually every aspect of Euro Area governance, including at length on banking resolution arrangements, and on policy details in Europe down to fantastically small details—highlighted by the voluminous conditionality set in the Greek programs—it has remained totally silent on the critical matter of sovereign insolvency arrangements specifically for the Euro Area. It is a further example of the remarkable distraction that bedevils IMF surveillance.

There are better ways forward for the Euro Area. Better does not mean easy—nothing is easy in a currency arrangement which is still as badly misconstructed as the Euro Area is. But the way forward require the aspiration to find a universal global approach within the constraint of reliance on CACs to be abandoned.

One illustration of the nature of options which should be considered has been provided by the CIEPR here. Their key summary table, which includes proposals for the Euro Area, is reproduced below. These suggestions innovate in various ways,

	No Solution	International Solutions			European Solution
Characteristics	**Status quo**	**Strong Aggregation**	**Immunization**	**Sovereign Debt Adjustment Program**	**European Sovereign Debt Restructuring Regime**
Type	Contractual	Contractual	Limited statutory	Statutory	Statutory
Vehicle	Collective action clauses globally, plus aggregation clauses in the euro zone	Strong aggregation clauses: a supermajority among all bondholders receives full powers to restructure as long as all bondholders are offered equal terms	Law changes in major financial centers to immunize central counterparties, payments and clearing systems	New lending facility (SDAF) of IMF and (possibly) amendment of IMF articles to immunize against holdouts	New lending policies of ESM and amendment of ESM treaty to immunize against holdouts
Trigger	no trigger (de facto IMF also acts gatekeeper)	status quo	status quo	Country seeks financig from the IMF under a sovereign debt adjustment program	Country seeks financing from ESM
Process and Criteria for restructuring	No predictable process or criteria: IMF (or Troika) act as gatekeeper, diagnostician and prescription writer: prepares DSA, restructuring is a possible outcome but criteria are not fully predictable	status quo	status quo	SDAF sets out the criteria for eligibility, IMF prepares debt sustainability analysis, detailing the contributions expected from official and private creditors	Below 60% debt threshold near-unconditional access, above 60% EMS may only lend with conditionality and above a second threshold ESM may only lend with debt restructuring
Amount of restructuring and loss sharing	Not clear ex ante: Debtor country negotiates with creditor groups, formulates restructuring proposal, IMF (or Troika) reviews to ensure that the proposal is in line with the assumptions of the Debt Sustainability Analysis	status quo	status quo	In principle like status quo but minimus restructuring to restore debt sustainability could be defined ex ante	Minimum restructuring to bring debt below upper threshold, short term debt is subject to a higher haircut
Rights and remedies of holdouts	No effective limit: holdouts can use remedies to attach payments and revenue streams of debtors	Affects rights of holdouts: reduces their ability gain advantage by buying small series	Affects remedies of holdouts: immunizes assets and revenue streams of a restructured debt instrument	Affects remedies of holdouts: immunizes assets and revenue streams of a debt instrument that was invited to participate in a IMF approved SDAP	Eliminates the rights of holdouts of a debt instrument that was invited to participate in a ESM restructuring program become unenforceable in the territory of the euro zone
Geographical reach/ and timing	Depends on diffusion of contract	Need to be introduced in a coordinated fashion by large borrowers in advanced and emerging markets, but would take many years to become effective	If adopted in all mayor financial centers the reach could be almost universal, debt transactions would migrate to the centers offering immunity, effective immediately	Territories of IMF member countries, effective immediately	In principle the euro zone but other countries could join on a voluntary basis, effective immediately
Limiting contagion and fallout of sovereign restructuring	No global instruments to deal with contagion, (except CCLs); national defenses (hoarding of FX reserves, capital controls and ring-fencing of banks)	status quo	status quo	status quo	Banking Union and single bank restructuring and resolution regime to complement and limit fallout from sovereign restructuring
Incentives					
Ex ante: incentives for better debt management	Weak	Weak	Weak	Medium (SDAP will improve predictability but discretion remains with the IMF)	High powered since debt thresholds are transparent and predictable, risk premia will reflect this
Ex ante: incentives to prevent procrastination	Weak	Weak	Weak	Medium (SDAP will improve incentives but discretion remains with the IMF)	High powered since price reaction ex ante will be stronger as debt thresholds are approached
Ex post: prevent holdouts	Weak	Weak/medium (depending on the adoption of strong aggregation clauses)	Medium/strong depending on how many jurisdictions immunize	Strong	Strong

including shifting the management of insolvency from creditors to Euro Area authorities, applying write down rules oriented towards Euro Area stability concerns rather than the ad hoc interplay of negotiating positions of individual debtors and their creditors. and, thereby, abandonment of reliance on CACs.

As these suggestions stand, there is need to flesh them out considerably in several key dimensions. I will do this in a forthcoming paper.

Pending that, the key point for purposes of this piece is to emphasize that the IMF has failed to offer any thoughts on sovereign debt restructuring structures for the Euro Area in any of their many contributions to debates on EA institutional reforms. And the proposals the IMF offers on sovereign debt restructuring globally will, if adopted in the Euro Area, make matters there, which are already fragile enough, worse.

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