

## ADEMU WORKSHOP

# Legal and Institutional Dimensions of EMU: Economists and Legal Scholars in Discussion

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"CAC and sovereign debt restructuring in the Euro Area"

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December 11th, 2015

# Main points of the paper

1. Definition of Collective Action Clauses (CACs)
2. An example of their use
3. Pertinent legal reforms since the Eurozone crisis
4. The future of debt restructuring in the Eurozone

# 1. What are Collective Action Clauses (CACs)?

- ▶ Modification to payment terms of government bonds ("Debt Restructuring") requires consent of all contracting parties
- ▶ This gives rise to strategic behavior on side of lenders and so process is often costly and unpredictable
- ▶ CACs make debt restructuring agreement reached with qualified majority of bondholders binding for all of them
  
- ▶ Public debt instruments are general obligation bonds  $\Rightarrow$  debt restructuring = partial default
- ▶ Default mainly studied in developing economies. Focus was external debt puzzle.
- ▶ Most influential paper for developed economy (Argentina) from 2008: "Unorderly" default has two main costs:
  - ▶ Restricts from future borrowing/drives up interest rate
  - ▶ Creates and sustains disruptions on economic activity

## 2. An example of their use: Greece

- ▶ 2012: Debt restructured using "retroactive statutory CACs"
- ▶ Possible because bonds were governed by Greek law
- ▶ All legal challenges eventually dismissed
  
- ▶ Changing a debt agreement unilaterally and ex-post should be worst for future borrowing cost
- ▶ EMU economies are special cases in twofold way:
  - ▶ Are all developed economies
  - ▶ Debt is denominated in quasi-foreign currency (cannot be printed away)

### 3. Pertinent legal reforms since the Eurozone crisis

Since January 2013, ESM Treaty requires all Eurozone sovereigns to include identical CACs

- ▶ Harmonizes potential debt restructurings
- ▶ Majority refers to all affected bonds, not just one at a time
- ▶ Contractual CACs (as opposed to retroactive statutory ones) reduce risk of legal disputes
  
- ▶ How many countries affected by this change?
- ▶ Reform might lead to different (ex ante) strategic considerations of investors. Example:
  - ▶ Focus on public debt of a particular (small) EMU economy
  - ▶ Form blocking coalition with other focused debt holders
- ▶ Composition of lenders might change

## 4. The future of debt restructuring in the Eurozone

According to the ESM Treaty debt restructuring

- ▶ is a complement to ESM assistance (not alternative) to be used in "exceptional circumstances"
- ▶ should take into account loss absorbing ability of creditors
- ▶ aims for debt relief to level that assures EZ financial stability
- ▶ targets the private sector. (IMF, ESM are preferred creditors; status of ECB not clear.)
- ▶ Will (application to) financial assistance from ESM trigger restructuring? Who decides on exceptional circumstance?
- ▶ How concrete is the Treaty on loss absorbing ability and EZ financial stability? Losses might be pushed on ECB.
- ▶ Will bonds held by ECB due to OMT be affected? If yes: fiscal risk introduced to monetary policy operation.

## Some thoughts on the future of public debt

The ceteris paribus effect of CACs on interest rates is not obvious

- ▶ Reduces inefficiency costs of debt restructuring (-)
- ▶ Makes full default less likely but partial default more likely (+)
- ▶ My best guess: CACs reinforce disciplining role of markets  
⇒ EMU interest rates will become distinct (again)

Is the concept of general obligation ("uncontingent") government bonds an increasingly questionable ingredient of economic models?

- ▶ Developed economy governments seem increasingly unable to extort resources (political and/or administrative reasons).
- ▶ "If a state goes bust, it is obviously not the state who is broke but its citizens." (Carl Fuerstenberg)
- ▶ However, risk free interest rate is a key element of economic thinking and modeling
  - ▶ People do not like uncertainty ⇒ Are willing to pay a premium for a guaranteed ("in any state of the world") return