Deutsches Institut für Entwicklungspolitik
German Development Institute

Learning from the Greek fiasco – we need an insolvency procedure for states

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The Current Column
of 18 July 2011

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Bonn, 18 July 2011. On Thursday Euro area Heads of State or Government will convene in Brussels for a crisis summit to once again discuss Greek aid and Euro Zone stability. In Brussels the buy-back – financed by the European rescue fund – of government bonds issued by the crisis-hit countries is currently under discussion. The International Monetary Fund (IMF) and the Euro area finance ministers in early July had made further billions available. But the fire had been extinguished only for the time being. The markets react nervously and are now even targeting the relatively stable Italy. Do Greece and the other crisis countries really have *only* a liquidity problem – as is stated by the European Central Bank and the German *Bundesbank* – or is Greece insolvent, as is assumed by most finance experts? And how is bankruptcy to be handled?

A state is insolvent when it is persistently unable fully to settle payable claims. If Greece is insolvent, debt restructuring combined with what is known in the financial world as a haircut, would be absolutely essential. For this, however, there is at present no agreed procedure in the European Monetary Union (EMU). Only ad hoc debt restructuring is possible. The only way to facilitate coordination among creditors in the event of restructuring is to include collective action clauses in government bonds. But such clauses do not provide a solution now because only some bonds currently contain them. They will be included in all new euro-area government bonds from June 2013 onwards. In the future this will facilitate the equal treatment of all creditors, and free riding by individual creditors will be more difficult.

An insolvency procedure – the light at the end of the debt tunnel?

An alternative to delaying a haircut by providing ever more loans, the approach that has been adopted for a year now, would have been an insolvency procedure for states analogous to insolvency procedures for enterprises. A state's debts would then be restructured and reduced in accordance with previously agreed, binding rules. Majority decisions would be binding for creditor minorities.

A great advantage of insolvency procedures is that the burden is shared evenly by public and private creditors. This is particularly important if the procedure is to be accepted in creditor countries. There is then no danger of a unilateral rescue by government budgets – and so by the taxpayer.

Ad hoc debt restructuring, on the other hand, often delays processes. Creditors fear not only the partial loss of their claims but also a lack of equal treatment. Debtors delay restructuring because it is associated with reputation loss, which may result in restricted access to international financial markets for a long time.

Prolonging debt restructuring is often very costly. Debtors – like Greece – then have to implement strict austerity programmes and pay high rates of interest on new loans. Major social costs and political unrest are the consequence. In addition, the burden of restructuring is often unevenly distributed among the creditors. In Greece many private creditors have abandoned the sinking ship, and public creditors have to meet the cost of restructuring. The EMU members and the IMF are currently providing the lion's share of the new financial injections. The absence of restructuring rules is also causing uncertainty among market operators, and there is a risk of other EMU countries being infected, as Italy demonstrated last week.

Another argument for the introduction of an insolvency procedure in the EMU is that the institutional conditions are favourable: as the EMU-countries belong to the EU, supranational institutions governed by common legislative rules that take precedence over national laws already exist. Equally, the connection with European institutions might help to ensure impartial decision-making structures.

Problems associated with insolvency procedures

If it is so simple, why is it that an insolvency procedure for states was not introduced in the EMU long ago? Many are firmly opposed to debt cancellation because of that well-known phenomenon, moral hazard: the risk of a debtor country deliberately accepting an insolvency procedure in order to reduce its debts. An insolvency procedure therefore needs to be so arranged as to preclude such strategic behaviour. Sanctions might be introduced to prevent a debtor from opening an insolvency procedure without justification. The debtor would then have to meet the cost of the procedure. A restructuring plan could also be declared void, and the debtor would not be allowed to initiate a new procedure.

Another risk is that a debtor who initiates an insolvency procedure will lose access to the international capital markets. But as that access depends on the country's overall economic situation and the assessment of its future development, an insolvency procedure must be combined with economic reforms. Many heavily indebted countries will in any case have lost access to international capital markets before the procedure is opened.

For Greece an insolvency procedure is already out of the question, because it should already be in the process of implementation. The only option in this case, then, is an ad hoc debt arrangement, such as the haircut currently under discussion in Brussels, based on a buy-back of government bonds. An insolvency procedure might be the solution in future cases. The aim of such a procedure, predictable for all concerned, should be to prevent other crises from spreading like a bushfire in the euro area.

Insolvency procedure for developing countries?

If lessons can be learnt from the Greek case and an insolvency procedure can be established in the EMU, there will also be a chance in the medium term of its becoming a fixture in the international financial architecture for all countries. The introduction of an insolvency procedure for states in the context of developing countries has long been under discussion, there being no systematic procedure for restructuring and reducing their debts.

Instead, such temporary debt reduction schemes as the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative dominate. Although these initiatives have greatly reduced the debt mountains in most developing countries, they are "one-off" and are due to expire in the near future. What then? Among the developing countries and emerging economies, too, there will undoubtedly be further cases of excessive government indebtedness in the future.

One solution would be a permanent insolvency procedure for states. In its coalition agreement the German government committed itself to supporting the introduction of an insolvency procedure for developing countries, but the ruling coalition has yet to put forward a proposal or launch an international initiative in this respect.

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