Collective Action Clauses and Sovereign Debt Restructuring Frameworks: Why and When is Restructuring Appropriate*.

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In this paper, I will first make a few considerations about the legal aspects of Collective Action Clauses (CACs) in the context of the Eurozone and then approach the broader economic issue of why it may be useful to have more efficient CACs, such as single-limb CACs, and when and in what circumstances it may be appropriate to restructure sovereign debts.

1. Considerations on CACs.

1.1 Are CACs the Only Way?

The first issue that arises in the context of existing Euro CACs – the so called dual-limbed CACs that were mandatorily introduced for all Eurozone sovereign bond issuances made after January 2013 – is whether they are the only tool available to the authorities or if they are but an additional option. The latter view has been argued by several authors and emerges forcefully in a recent paper by Mark Weidemaier.[1] The argument is essentially that of the so called "Local Law Advantage", that can be applied to the great majority of the outstanding bonds that are subject to the local law. According to Weidemeier:

> This 'local law advantage' makes it comparatively easy for a government to restructure its debt. To use an extreme example, a government might enact legislation imposing a 50% tax on payments to bondholders. Less extreme examples are easy to find. In 2012, Greece achieved debt relief of over 50% of GDP by passing a law providing for a collectively-binding restructuring vote taken across most of the country's local-law debt stock. The recent restructuring in Barbados has followed a similar approach.

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[1] Weidemaier (2019). See also Gulati (2019).

On this issue, since I am an economist and not a jurist, I think that rather than reporting my personal view, it is more useful if I report the view of the Italian authorities, by which I mean the people in charge of debt management at the Treasury and at the Bank of Italy. Italian authorities, and their legal departments, claim that CACs are the only way, in the sense that it is compulsory to use them in the event of a need to restructure a Euro area nation's sovereign debt. The argument is that the goal pursued by authorities and by the technical committee that drafted the euro CAC regulation in 2012 was to have a uniform and predictable system for all future debt restructurings throughout the Eurozone. Or, to put it differently, that the strategy of using a retrofit CAC in Greece in March 2012 would not repeated. To this effect, it is recalled that art. 12 (par. 3) of the ESM Treaty give emphasis to the notion that CACs should have identical effects in all member state. The article states that:

> Collective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical. (emphasis added).

Moreover, the preamble of the Treaty explains:

> In its statement of 28 November 2010, the Euro Group stated that standardized and identical Collective Action Clauses ("CACs") will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro area government bonds. (emphasis added).

A couple of years ago, a Report of Mediobanca Securities (2017) caused some discussions in the markets since it argued (or took for granted) that bonds issued after Jan. 2013 with Euro CACs could no longer be redenominated (except with a large supermajority of investors). Lorenzo Codogno and I consulted with a number of experts on international law and found that their overwhelming opinion was that the Mediobanca report was mistaken.[2] The reason being the local law advantage. So, it would appear that the answer is different if one asks about debt restructuring or about redenomination of the debt. This apparent contradiction probably has a simple explanation. Redenomination is itself a breach of European law, given that there is no legal way to exit the euro;

[2] Codogno, L and Galli G. (2017).

so should a country choose to exit, it would expect to face an enormous amount of litigation, independently of what the CACs say or do not say. Instead, a country that wants to stay in the Euro area, but needs to restructure its debt, would probably try to avoid any unneeded litigation. It hence would not make sense for such a country to eschew the use of the Euro CACs.

In other words, using CACs seems to be a safe way to do things. Other ways are theoretically possible, but are filled with difficulties, as they would give rise to extreme litigation. Investors would probably be able to have recourse to the Constitutional Court and the European Court of Human Rights.

This conclusion is in line with what Weidemaier himself concludes:

> From the perspective of the restructurer, Euro CACs represent the safe option, not the only one. A sovereign that satisfies the Euro CAC's voting requirements can rest easy; its restructuring will leave no holdouts and will survive almost any legal challenge. But a sovereign that has issued local-law debt remains free to alter its law to facilitate restructuring. This path involves more risk. The sovereign is constrained by its own law and institutions, by international law, and (in the Euro Area) by European law and institutions. Yet the constraints are not absolute; there is room for the prudent exercise of local law advantage. I doubt a Euro Area sovereign would eschew CACs without good reason, but the option is there.

1.2 CACs and the Italian Consolidated Act on Public Debt

In the case of Italy, the idea that CACs are not the only way to do a debt restructuring is reinforced by the interpretation that both Weidemaier (2019) and Gulati (2019) give to the Consolidated Act of 2003 that establishes principles and responsibilities for the management of the public debt[3]. According to their interpretation, the law allows the Treasury to take all sorts of unilateral actions to restructure without even requiring new legislation.[4] It is thus of some importance to inform you that Italian authorities, and their legal departments, do not agree. Instead, they suggest a radically

[3] Decree of the President of the Republic of December 30, 2003, no. 398 (published in the Official Gazette of 9/3/2004, Supplemento ordinario no. 37).
[4] See Edelen, A., et al. (2013).

different interpretation: the word "restructuring" used in that law stands for voluntary operations that are done on routine basis, including such simple things as issuing long term bonds rather than short term and vice versa, since these are ways to change the maturity structure of the debt. There is a decree of the Treasury Minister that gives this interpretation.[5] The authorities have no doubts that a different interpretation would be deemed unconstitutional.[6]

1.3 Towards Single-limb CACs

Since 2013, the discussion on CACs in Europe, as well as at the IMF, has made progress and there now seems to be a consensus that single-limb CACs are a better choice. They are considered more efficient, because they allow a sovereign to restructure more rapidly - a single vote would be required rather than multiple votes for each series of bonds - and more effectively, since the problem of holdout creditors is minimized. At the Eurogroup meeting of November 19, 2018 member countries expressed "broad support for the introduction of the single limb CACs, as part of a comprehensive package of EMU reforms".[7] The intention is to introduce a single limb feature in the CACs as an amendment to the ESM Treaty. Single-limb CACs have also been deemed useful by the ECB.[8]

Not surprisingly, the Italian authorities in charge of debt management are not keen about them because they fear that their introduction might send a negative message to the markets. In this respect, it is worth noting that the current CACs were conceived in 2012 as a rather complex instrument, giving creditors a greater say in the matter, in part to avoid giving the impression to the markets that their purpose was to make restructuring excessively easier.

2. Why and when do we want to make it easier to restructure the debt?

[5] Decree of the Minister of Economy and Finance, n. 99912, 12 December 2012.
[6] For a discussion of the question, as it was raised in the context of the Greek restructuring of 2012, see Manuelidis (2019) [*paper in this volume*].
[7] See the letter of the President of the Eurogroup of November 30, 2018.
[8] See the papers by Yves Mersch and Otto Heinz in: *ESCB Legal Conference (2016)*.

In which context, do we think that restructuring should take place? And how deep should be restructuring? Here I would like to spend a few words to answer a question that was put forward at the sidelines of this EUI conference by Jeronim Zettelmeyer in informal conversations. He asked:

> Why there is much skepticism among Italian economists about the "Franco-German" idea of making debt restructuring a more feasible option of the euro architecture?

I will do my best to answer this question, although I should make clear that here I am expressing my own personal opinions and do not claim to represent the economics profession in Italy.

Before, presenting the analytical arguments, let me say that:

a. Defaults and restructuring can happen. They are a fact of life, whether or not they are a rational choice. One cannot conceive a federation of states in which some states provide an unlimited guarantee to other states. In these cases, having a more efficient way to restructure, as with single-limb CACs, is probably desirable.
b. I believe that market discipline usually works better than UE budgetary rules. Moreover, I sympathize with the idea of making markets do the work in a better and more effective way. Much too often we see markets reacting too slowly and too abruptly, a point that was made in the Delors Report, and that is the logical underpinning of the system of fiscal rules that we have in the EU.[9] This means that governments live under the illusion that they can pile up mountains of debts and keep refinancing it at low rates. And the realization that that strategy will not work perpetually does not arrive in the minds of the government officials and politicians until it is too late.
c. I realize that sovereign restructuring may be unavoidable and perhaps appropriate under some circumstances, which are mainly the following: i) a country asks for external assistance, which means money of foreign taxpayers; ii) the restructuring is part of a package agreed with official creditors aimed at fiscal rectitude and is by no means a substitute for fiscal rectitude; and iii) the restructuring is not too large in a sense that I will try to make clear.

[9] See Committeri, M. and Tommasini P. (2018).

Having said the foregoing, one should be clear about the ultimate goal of what we are doing: that is convincing Italy to implement a credible plan to improve its budget, according to European rules. The goal cannot be the restructuring of the debt: a restructuring in the absence of a credible fiscal plan would be a tremendous problem for Italy and cause harm to the rest of the Eurozone as well.

So what I am objecting to is the idea that restructuring is a way to "solve the problem of the debt", i.e. that it is an alternative to fiscal rectitude. Restructuring can at best be a complement to fiscal rectitude, unless it is a necessity. Then, however, we are not talking about rational choices, but, at best, about disaster management. I will explain why below.

a. The critical thing to have in mind is that restructuring the Italian debt is a different story from the various emerging markets countries dealt with by the IMF in recent decades and also from Greece. The reason is that in these cases, most of the debt was held by foreign banks or by a small number of wealthy nationals who held domestic bonds through illegal foreign deposits. In these cases, restructuring imposed a burden on foreign institutions and a few wealthy nationals. In the case of Italy, it would impose a substantial burden on domestic residents who hold the debt either directly or through (mutual or pension) funds. Residents hold about 70% of the debt in Italy today, while they held roughly 30% in Greece in 2012.[10] This is an essential difference from a social and political point of view.
b. There are also different economic consequences, because, when the debt is large and widely held by the population, a restructuring of the debt will be detrimental to domestic demand, through three main channels: (i) wealth effects on consumption, because restructuring is a tax on wealth; (ii) reputational effects that may prevent private companies to access markets for quite some time given that corporate ratings are linked to sovereign ratings and both would be at junk level; and (iii) a credit crunch, since bank capital would be eroded by the loss on government bonds. The importance of this argument depends on how large the restructuring is. Here, I come to the critical analytical argument.

[10] 17.3% of the total debt (euro 2,317 billion, including a small portion of loans) is held by the Bank of Italy, 28.2 by Italian banks, 19.6 by Italian non-bank financial institutions, 5.3% by other Italian residents, and 29.5 by non-residents. Bank of Italy, The public finances: borrowing requirement and debt, March 15, 2019 (data as of Dec. 31, 2018).

c. A small restructuring will cause the markets to expect a bigger one, and capital flight will be huge (unless accompanied by a significant shift in budgetary policy to make the debt sustainable in the context of an agreement with official creditors).

d. In turn, this means that the restructuring makes sense only if it is large, in the sense that it is a definitive and credible solution to the problem of the debt. This means that a debt of 130% of GDP must be cut down to something like 80 or 90 per cent. This move is bound to cause a major recession, through the three channels mentioned above. In addition, the restructuring (which should involve a strong reprofiling) would have to be accompanied by very tight budgetary policy both to minimize the need to tap the markets the next day and to regain credibility. These actions would aggravate the fall in domestic demand. ESM and IMF resources can smooth the transition and allow a country to continue running a small deficit for some time, but at the end of the transition, after 3 or 4 years, the country must be able to regain access to the markets, which in any case requires that the budget be brought in equilibrium (which essentially means balanced budget). In the end, fiscal rectitude is necessary, whether or not there is a restructuring, but it is more difficult to exercise if there is a restructuring because the latter damages domestic demand and does not do much to reduce the primary surplus that is needed to put the debt on a downward path[11].

e. To these considerations, one should add that a large part of the debt (like in the case of Greece) is held by domestic banks, which following a restructuring would need to be recapitalized, otherwise one would not only have a credit crunch, but a full-fledged banking crisis. This means that the state would have to ask for official loans, implying that on this part of the debt there would be little or no relief.

3. Some Tentative Conclusions

Given these considerations, I propose the following tentative conclusions:

a. A small restructuring is likely to aggravate a fiscal crisis because agents will come to expect a more extensive restructuring. (This will not occur only if the restructuring is part of a credible package to make the debt sustainable through a higher primary surplus).

[11] If (r-g) is around zero, the level of the debt ratio is irrelevant for debt dynamics. If it is +1%, then having an initial debt ratio of – say- 90% instead of 130% makes a difference of 0.4% of Gdp in the level of the primary surplus that is needed to keep the debt constant. With a r-g= 2%, the difference would be 0.8%, still less than one per cent of Gdp.

b. A large restructuring, on the other hand, bringing the debt down from – say- 130% to 80%, will cause serious damage to domestic demand, thus making it more difficult to put the debt ratio on a sustainable path. Such negative effects could last for several years because of the loss of reputation in the markets.
c. At the end of the story, the budget must be balanced, and the level of the debt makes a relatively small difference in the primary surplus that is needed. Hence, the path to fiscal rectitude is far less painful without restructuring because restructuring reduces the debt, but causes significant damage to domestic demand. It is obvious, but it is worth repeating, that if the government never undertakes fiscal responsibility, then default and restructuring became a necessity, but – I should add - a dramatic necessity.
d. I doubt that there can be such thing as an orderly restructuring when the debt is large and is held by millions of domestic savers. Major financial disruptions are to be expected as well as social and political tensions of great magnitude. The experience of Argentina in 2000-2001 probably gives one a sense of how bad things can get. Or the Weimar Republic, when the government's default on the real debt annihilated the middle class of Germany.[12]
e. I also doubt that there can be such a thing as an early restructuring. In the sense that no government will ever decide to restructure the debt unless it is already close to a state of default and bond prices have already collapsed; only then the government can offer a slightly better deal to bondholders and in this CACs can be quite useful. An early restructuring is a cold blooded pistol shot in the heads of innocent savers[13]. It is much worse than bank fraud, for which there are penal responsibilities in all countries. The government cannot behave worse than Enron and Lehmann put together; in any case, if it does, it would be lynched by the populace, not only by the electorate. Besides, in Italy, as in most other countries, an early restructuring would likely be held in local courts to be unconstitutional, because the Italian judicial system is based on the rule of law and the protects property rights and, specifically, savings; expropriation is possible for reasons of public interest, but only with due indemnification.
f. A moderate restructuring, i.e. one that does not cause a significant recession, may be appropriate in the context and as a complement of a package agreed with official creditors

[12] Alesina A., (1988).
[13] A preemptive restructuring, i.e. that occurs before technical default on some payments, may instead be useful in making the restructuring less disorderly and costly. See Asonuma T. and Trebesch C. (2015) and Sturzenegger, F. and Zettelmeyer J. (2006).

aimed at increasing the primary surplus. Actually, in such cases a wealth tax would probably be more equitable, but it may be more difficult to implement. In any case, restructuring cannot be a substitute for fiscal responsibility.

g. Such moderate restructuring in the context of a program can and should be done but in a discretionary fashion. Existing rules, namely the no bail-out clause and the requirement that the debts of countries applying for ESM support be sustainable, already provide a framework for such discretionary solutions, aimed primarily at avoiding moral hazard.

Finally, let me add that whatever we do now with ESM rules and CACs, it is crucial not to repeat the mistake that was done in 2010 in Deauville. When markets learnt about PSI, contagion effects were significant and markets were destabilized in several Eurozone countries.[14] For this reason, these issues must be handled with great care.

[14] Bini Smaghi Lorenzo (2018).

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