

## NOTES

# MANAGING SOVEREIGN DEBT: A MORE LONG-TERM DEBT- RESTRUCTURING SOLUTION

STEPHAN AIRAPETIAN\*

*[W]e lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors.*

- Anne Krueger<sup>1</sup>

### I. INTRODUCTION

Experiencing the deepest recession in decades, the United States' economy faces a laborious path to fiscal balance.<sup>2</sup> Recovery seems questionable and is hampered by a \$1.1 trillion budget deficit in 2012.<sup>3</sup> The Congressional Budget Office's ("CBO") medium and long-term projections for the United States remain unsustainable.<sup>4</sup> Even in the CBO's unrealistic best-case scenario—Congress doing nothing to amend current legislation and allowing major tax provisions to expire—the United States is projected to have a cumulative \$3.1 trillion deficit from 2013 to 2022.<sup>5</sup> Additionally, the debt ceiling, one of the mechanisms for limiting U.S. debt, has been

---

\* J.D., 2013 University of Southern California Gould School of Law. Special thanks to Professor McCaffery for his invaluable guidance.

1. Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, Address to National Economists' Club Annual Members' Dinner: A New Approach to Sovereign Debt Restructuring (Nov. 26, 2001), available at <http://www.imf.org/external/np/speeches/2001/112601.htm>.

2. See Alan J. Auerbach & William G. Gale, *The Federal Budget Outlook: No News Is Bad News*, 136 TAX NOTES 1597 (2012).

3. Annie Lowrey, *Federal Deficit for 2012 Falls to \$1.1 Trillion*, N.Y. TIMES, Oct. 12, 2012, <http://www.nytimes.com/2012/10/13/business/federal-deficit-for-2012-fiscal-year-falls-to-1-1-trillion.html>.

4. See Auerbach & Gale, *supra* note 2, at 1597.

5. *Id.* at 1598.

ineffective, because it has been raised seventy-eight times over the past half century.<sup>6</sup>

However, compared to Greece's 152.6% debt-to-gross-domestic-product ("GDP") ratio,<sup>7</sup> the United States' 104.8% debt-to-GDP ratio looks exemplary.<sup>8</sup> Since the Greek financial crisis started in late 2009, two bailout packages have been approved in order to help Greece avoid bankruptcy.<sup>9</sup> Surprisingly, Greece had one of the fastest growing economies in the European Union from 2000 to 2007;<sup>10</sup> however, many analysts, including Fitch Rating, now predict that a Greek default is "highly likely."<sup>11</sup>

Even though Greece's debt problems might not be the best corollary for the United States' debt problems, the United States can learn a lot from the Greek financial crisis. Unlike the Greek debt that is mostly owned by European banks,<sup>12</sup> the United States' debt is more spread out.<sup>13</sup> The United States also owns its own currency and can devalue it whenever it wishes,<sup>14</sup> whereas Greece cannot devalue its currency without leaving the European

6. Richard Wolf, *Debate Over U.S. Debt Limit Is Going Down to the Wire*, USA TODAY (June 16, 2011, 5:11 PM), [http://www.usatoday.com/news/washington/2011-06-15-debt-limit-debate\\_n.htm](http://www.usatoday.com/news/washington/2011-06-15-debt-limit-debate_n.htm) ("In the past half-century, Congress has acted 78 times to raise, extend or revise the debt limit—the amount of money the government can borrow to repay bond holders. The red ink has risen 49 times under Republican presidents, 29 times under Democrats. It's gone up 10 times since 2001.")

7. *Euro Area and EU27 Government Debt Nearly Stable at 90.0% and 85.1% of GDP Respectively*, EUROSTAT (Jan. 23, 2013), [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/2-23012013-AP/EN/2-23012013-AP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-23012013-AP/EN/2-23012013-AP-EN.PDF) [hereinafter *Euro Area Government Debt Up to 90.0% of GDP*].

8. BUREAU OF ECONOMIC ANALYSIS, <http://www.bea.gov/national/index.htm> (last visited Mar. 22, 2013); TREASURY DIRECT (debt measure on Dec. 31, 2012), <http://www.treasurydirect.gov/NP/BPDLogin?application=np> (last visited Mar. 22, 2013).

9. *Greece*, N.Y. TIMES (Oct. 9, 2012), <http://topics.nytimes.com/top/news/international/countriesandterritories/greece/index.html>.

10. AGGELOS TSAKANIKAS, MICHALIS VASSILIADIS & ELIAS DEMIAN, *THE GREEK ECONOMY UNDER REFORM* (2012), *available at* [http://www.kas.de/upload/dokumente/2012/12/121210\\_presentation\\_tsakanikas\\_vassiliadis\\_demian.pdf](http://www.kas.de/upload/dokumente/2012/12/121210_presentation_tsakanikas_vassiliadis_demian.pdf).

11. *Greece Default Likely, Says Fitch*, COURIER-MAIL (Feb. 23, 2012, 2:17 AM), <http://www.couriermail.com.au/ipad/greece-default-likely-says-fitch/story-fn6ck55c-1226278898611>.

12. Boris Groendahl, *German Banks Top French With \$23 Billion in Greek Debt, BIS Report Shows*, BLOOMBERG (June 6, 2011, 1:02 AM), <http://www.bloomberg.com/news/2011-06-05/german-banks-top-french-with-23-billion-in-greek-debt-bis-says.html>.

13. *Major Foreign Holders of Treasury*, <http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt> (last visited Mar. 22, 2013).

14. Natascha Gewaltig, *Greece's Painful Choice*, BUSINESSWEEK (Feb. 19, 2010), [http://www.businessweek.com/investor/content/feb2010/pi20100218\\_722508.htm](http://www.businessweek.com/investor/content/feb2010/pi20100218_722508.htm).

Union.<sup>15</sup> Despite these differences, the Greek economic crisis highlights the need for international safeguards against future debt crises. The United States might need such safeguards in the future due to its massive economy and position as a world power.

Due to globalization and countries' use of sovereign bonds, the possibility of a large systematic collapse when a debtor nation defaults on its loans has increased.<sup>16</sup> The fear of a larger economic collapse has led to another problem—"too big to fail." Too big to fail ("TBTF") concept applies when countries or banks do not allow another country or bank to fail because they fear that doing so would spark an economic domino effect that could trigger further worldwide financial collapse.<sup>17</sup> In these situations, the International Monetary Fund ("IMF") and other international banks try to mitigate a default by restructuring debt and underwriting bailout packages.<sup>18</sup> This perplexity can be "summed up by Keynes's adage: 'If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours.'"<sup>19</sup>

In turn, the availability of TBTF protection leads to morally hazardous<sup>20</sup> government actions that increase the chances of a default. Governments take on more risk and act without much regard to consequences because they expect other countries to protect them against bankruptcy.<sup>21</sup> This causes governments to misallocate their resources and overspend.<sup>22</sup> Further, government officials may be reluctant to maintain the budget and to avoid default by reducing social welfare<sup>23</sup>—citizens tend not to vote for officials who reduce social welfare.<sup>24</sup>

---

15. See Gordon Kerr, *Devaluing the Pound Isn't a Solution, It's Default*, BLOOMBERG (July 4, 2012) <http://www.bloomberg.com/news/2012-07-04/devaluing-the-pound-isn-t-a-solution-it-s-default.html>.

16. Steven L. Schwarcz, *Sovereign Debt Restructuring Options: An Analytical Comparison*, 2 HARV. BUS. L. REV. 95, 97 (2012); GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 2 (2004).

17. Schwarcz, *supra* note 16, at 97.

18. *See id.* at 96–97.

19. *Default Options: The Euro Zone's Leaders Are Seeing Their Political Choices Narrow*, ECONOMIST (June 23, 2011), <http://www.economist.com/node/18866915> [hereinafter *Default Options*]

20. See Mark V. Pauly, Comment, *The Economics of Moral Hazard*, 58 AM. ECON. REV. 531, 531 (1968).

21. STERN & FELDMAN, *supra* note 16, at 17.

22. *Id.*

23. See Giuliano Bonoli, *Political Institutions, Veto Points, and the Process of Welfare State Adaptation*, in THE NEW POLITICS OF THE WELFARE STATE 238, 239 (Paul Pierson ed., 2006).

24. *See id.* at 246–47.

The use of debt-restructuring contracts can provide a partial solution to the problems associated with sovereign debt and TBTF. Debt-restructuring contracts provide a mechanism to help sovereign debtors avoid defaults, but they do not provide a way for the debtor to make policy adjustments. The deals between creditor and debtor nations “delay[] debt repayment[,] . . . reduce[] amounts of principal, or reduce[] interest rates.”<sup>25</sup> Yet debt-restructuring contracts do not subject governments to policy changes, and lending countries are reluctant to require debtor countries to implement deep structural reforms.<sup>26</sup> Rather, it is during emergency bailout packages that lending banks provide financing subject to policy adjustments.<sup>27</sup> Even though banks cannot actually dictate policy, the option not to lend to the country provides adequate leverage to implement policy adjustments.<sup>28</sup> These policy adjustments will ultimately reduce a lending country’s deficit and prevent it from defaulting.<sup>29</sup>

Despite the ability of bailout packages to implement policy adjustments, bailout packages are not an ideal way to prevent a nation from defaulting. The problem with bailouts is the difficulty in distinguishing between transitory and permanent problems.<sup>30</sup> Bailouts require banks or governments to provide money to other failing governments even though there is a reason these governments are failing in the first place.<sup>31</sup> Nonetheless, governments and policymakers are still often willing to lend the money in order to “reduce the chance that the failure of a large bank in which creditors take large losses will lead other banks to fail or capital makers to cease working efficiently.”<sup>32</sup> Other factors that cause governments and policymakers to bail out banks are policymakers’ personal interests in advancing their careers and risky banking associated with incompetent central planning.<sup>33</sup> Due to the effects of TBTF, governments end up bailing out other governments, even if the failing

---

25. Schwarcz, *supra* note 16, at 99.

26. See Greece, *supra* note 9 (“[T]he parties that make up [Greek President] Mr. Papademos’s coalition feared that they were essentially being told to commit political suicide to save the country” by accepting the austerity plan associated with the second bailout package.).

27. See J.F. HORNBECK, U.S. DEP’T OF STATE, ARGENTINA’S SOVEREIGN DEBT RESTRUCTURING 5 (2004), available at <http://fpc.state.gov/documents/organization/39301.pdf>.

28. See *id.*

29. See *id.*

30. Edward Glaeser, *The Problem with Bailouts*, BOS. GLOBE, June 5, 2009, available at <http://www.hks.harvard.edu/news-events/news/news-archive/problem-with-bailouts>.

31. See *id.*

32. STERN & FELDMAN, *supra* note 16, at 2.

33. *Id.* See also Richard M. Salsman, *Banking Without the “Too-Big-to-Fail” Doctrine*, 42 FREEMAN 426, 426–27 (1992).

governments' financial structures and economies have permanent flaws.<sup>34</sup> In general, investing more money in governments with permanent flaws does not equate to smart investing, and it definitely does not fix the flaws.<sup>35</sup> Therefore, bailouts tend to be expensive and less preferable than debt restructuring.<sup>36</sup>

This Note compares and analyzes current debt-restructuring alternatives and proposes that debt-restructuring agreements should include clauses that implement austerity measures. The current debt crises in Greece and the United States will help demonstrate the need for more efficient and enforceable statutory debt-restructuring contracts. Part II will provide background and examine the TBTF phenomenon in the banking sector and explain the problems it creates for dealing with sovereign debt. Part III will discuss and compare current debt-restructuring alternatives: the free-market and statutory approaches. Part IV will argue that the current debt crises in Greece and the United States provide evidence that changes implementing long-term solutions need to be made to the current debt-restructuring practice. Part V will propose that a more efficient and beneficial debt-restructuring contract requires clauses that implement austerity measures on debtor governments.

## II. "TOO BIG TO FAIL"

The history of TBTF has closely mirrored the history of financial regulation in the United States.<sup>37</sup> Until the Great Depression, "the United States experienced banking panics roughly every 15–20 years."<sup>38</sup> In response to the Great Depression, the Roosevelt administration created "federal deposit insurance, securities regulation, banking supervision, and the separation of commercial and investment banking under the Glass-Steagall Act."<sup>39</sup> These measures were intended to reduce risk and maintain financial stability.<sup>40</sup> During the 1980s financial crisis, following the trend of maintaining financial stability, the United States bailed out Continental Illinois and other banks because it feared that their collapses would

---

34. STERN & FELDMAN, *supra* note 16, at 2; Salsman, *supra* note 33, at 426–27.

35. STERN & FELDMAN, *supra* note 16, at 2; Salsman, *supra* note 33, at 426–27.

36. *See* Schwarcz, *supra* note 16, at 96.

37. Imad Moosa, *The Myth of Too Big to Fail*, 11 J. BANKING REG. 319, 320 (2010).

38. *Id.*

39. *Id.*

40. *Id.*

negatively affect the financial system.<sup>41</sup> These government bailouts created the notion of TBTF.<sup>42</sup>

There are two issues that need to be addressed before the TBTF concept is further discussed: (1) why banks have been chosen for the discussion and (2) why the term TBTF might be misleading. Although this Note focuses on banks to explain the TBTF phenomenon, the TBTF phenomenon applies to commercial firms and sub-national governments as well—in each of these situations, policymakers must try to establish that their commitment not to bail out creditors is firm.<sup>43</sup> In the other sections of this Note, the TBTF concept will be discussed only in relation to national governments and sovereign debt. Moreover, the term TBTF might lead a person to believe that TBTF refers literally to government or bank size. However, bank size refers to a bank's holdings and therefore its increased importance in the financial sector. It is also important to note that governments sometimes do allow banks and other institutions to fail without providing any protection.<sup>44</sup> Although TBTF might be misleading, the term—even with its imperfections—is used because “the term TBTF is so firmly ensconced in the public debate.”<sup>45</sup>

The TBTF phenomenon requires two major features: protection of uninsured creditors and bank size.<sup>46</sup> Protection of uninsured creditors refers to the protection that countries provide to depositors in banks—for example, the United States government, through the Federal Deposit Insurance Corporation (“FDIC”), provides at least \$250,000 of insurance per depositor per insured bank.<sup>47</sup> Bank size refers to the bank's importance in the “country's financial system and its economic performance.”<sup>48</sup>

The TBTF problem arises when it functions as insurance for banks and creates what is referred to in economics as a moral hazard.<sup>49</sup> Even though there is a social benefit to buying insurance and, in effect, reducing

---

41. *Id.* at 320–21 (noting that, in the 1980s “the White House accepted the argument put forward by the Fed and FDIC that the alternative [to bailing out Continental Illinois] was to risk a systemic crisis in the financial industry”).

42. *See id.* at 320.

43. STERN & FELDMAN, *supra* note 16, at 16.

44. *Id.*

45. *Id.*

46. *Id.* at 12.

47. FDIC: FEDERAL DEPOSIT INSURANCE CORPORATION, <http://www.fdic.gov> (last visited Mar. 19, 2013).

48. STERN & FELDMAN, *supra* note 16, at 12.

49. *See* Pauly, *supra* note 20, at 531.

risk,<sup>50</sup> “insurance against some types of uncertain events may not be optimal”—meaning it may not lead to the best results and in turn not maximize utility, or get the greatest value possible from the expenditure of the least amount of money.<sup>51</sup> Rational individuals—assuming bank and government officials are rational—are expected to be utility maximizers and risk-aversers.<sup>52</sup> However, a “moral hazard reflects the hazard that arises from the failure of individuals who are or have been affected by insurance to uphold . . . moral qualities,”<sup>53</sup> and in turn, make rational decisions which maximizes utility. To clarify, moral hazard refers to a situation where a party will have a tendency to take risks because the party taking the risk will not feel the costs it incurs.<sup>54</sup> For example, if you ignore deductibles—a scheme by insurance companies to reciprocate against the moral-hazard problem<sup>55</sup>—a family who has flood insurance has less incentive to protect their home against floods than a family who does not own flood insurance because the family with insurance has less to lose if a flood occurs.

To further clarify, the TBTF problem arises when creditors expect to receive government funding or other protections if a bank fails.<sup>56</sup> Reliance on government protection causes creditors to become less risk-averse and to lose the incentive to monitor the bank’s actions.<sup>57</sup> At one point, creditors provided a source of regulation on banks because creditors would choose to not fund risky banks. However, with TBTF protection, creditors are willing to provide funds regardless of the bank’s risk.<sup>58</sup> For example, when a creditor is fully protected and will not suffer losses if a bank fails, the creditor has little incentive to monitor the bank’s activities and to withdraw funds if the bank is taking on too much risk. The creditor’s lack of risk aversion in turn affects the actions of the banks.<sup>59</sup> Banks engage in riskier

---

50. *Id.* at 532 (“There is a social gain obtained by purchas[ing] . . . insurance (as long as the insurer suffers no social loss) since pooling of risks reduces the total risk, and therefore the risk per insured, because of the Law of Large Numbers.”).

51. *Id.* at 531.

52. *See id.*

53. *Id.* at 535. Mark V. Pauly’s study explains the concept of moral hazard by focusing on the amount of medical coverage insured individuals use. For example, those with insurance will elect to visit doctors more and will have more tests done than what is medically necessary. Insured individuals will also engage in more risky physical behavior because they know they have medical insurance to cover any expenses if they are injured.

54. *Id.*

55. *Id.*

56. STERN & FELDMAN, *supra* note 16, at 11.

57. *See id.* at 17.

58. *Id.*

59. *Id.*

and less efficient transactions because they face less accountability.<sup>60</sup> TBTF causes banks to take on too much risk and to misallocate resources.<sup>61</sup> Due to TBTF protection, bank officials might be willing to finance risky projects that have limited potential to increase economic output.<sup>62</sup> Although the money invested in these projects has some potential to increase growth, the money invested is being put to lower-value uses—investments in less-risky projects might yield higher economic growth.<sup>63</sup> Thus, TBTF coverage has the potential to create inefficient banks and, in effect, inefficient governments.<sup>64</sup> Moreover, financial institutions have become so powerful that they are capable of “demanding (and obtaining) taxpayers’ money when things go wrong.”<sup>65</sup>

Moreover, bailout packages and other actions, influenced by TBTF policy, are also inefficient due to time inconsistency.<sup>66</sup> Time inconsistency refers to the fact that governments bail out failing banks only after a problem arises.<sup>67</sup> Therefore, policymakers tend to focus on the short-term benefits of the bailout, without considering the long-term impact of their actions.<sup>68</sup> Long-term policies are jeopardized in order to prevent one bank from failing and causing other banks to fail.<sup>69</sup> In time, this inconsistency leads to other problems. Consistently bailing out banks sets a precedent that enforces banks’ risky behavior, and only serves to reduce future welfare.<sup>70</sup>

Similarly, the TBTF phenomenon applies to national governments and sovereign debt. In an international framework, government debt defaults can have international systemic consequences, because other countries own sovereign debt. A default by one country could negatively impact other

---

60. *See id.* at 17–18.

61. *Id.* at 18. Misallocation of resources refers to a situation in which resources could produce more output if used in a different way. ARLEEN J. HOAG & JOHN H. HOAG, *INTRODUCTORY ECONOMICS* 200 (4th ed. 2006).

62. STERN & FELDMAN, *supra* note 16, at 18.

63. *Id.*

64. *See id.* at 17.

65. Moosa, *supra* note 37, at 325.

66. STERN & FELDMAN, *supra* note 16, at 19.

67. V.V. Chari & Patrick J. Kehoe, *Bailouts, Time Inconsistency and Optimal Regulation* 1 (Feb. 2010) (unpublished working paper), *available at* <http://www.crei.cat/files/filesActivitySummer/18/Chari%20Kehoe%20Bailouts%202010.pdf>.

68. STERN & FELDMAN, *supra* note 16, at 19.

69. *Id.*

70. Chari & Kehoe, *supra* note 67, at 2. When a government bails out firms, private agents will believe that the government will always bail out firms in the future; the expectations of such bailouts restrict future contracts and reduce future welfare. *Id.*



countries and the banks that hold the defaulting country's debt.<sup>71</sup> This forces countries to avoid financial collapses by either bailing out failing governments or restructuring their debts.<sup>72</sup> Conforming to TBTF theory, failing governments become more likely to engage in morally hazardous behavior and misallocation of resources. Not surprisingly, in a 2011 meeting with European policymakers, Greece's Finance Minister, Evangelos Venizelos, seemed to suggest that European policymakers "had no choice" but to save Greece from default because "a default would be more painful for the euro zone than for Greece."<sup>73</sup>

Although there are arguments that TBTF might be overemphasized in the banking sector, there is agreement that TBTF is an actual problem that affects governments and the banking sector.<sup>74</sup> Professor Frederic Mishkin argued that the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") improved banking regulation and made TBTF less severe.<sup>75</sup> The FDICIA closed banks with "least-cost" resolution, developed regulation lowering interbank exposure by requiring banks to maintain minimal capital, and made it more difficult for banks to be "bailed out."<sup>76</sup> Yet, Mishkin still acknowledged that TBTF is "a problem of important concern to policymakers."<sup>77</sup> Moreover, there is no legislation like the FDICIA that protects against TBTF with respect to governments and sovereign debt, even though governments' behaviors are analogous to the irrational risks TBTF banks take. The rest of this Note will assume that TBTF does have significant negative consequences for sovereign debt.

### III. DEBT RESTRUCTURING AS A TOOL FOR AVERTING FINANCIAL CRISIS

For those who study the history of economic trends, sovereign debt defaults should not be surprising; rather, they should be anticipated. Sovereign defaults have been the norm in every region of the world.<sup>78</sup> Defaults have, at times, been devastating for both the defaulting nation and

---

71. See STERN & FELDMAN, *supra* note 16, at 16.

72. *Id.*

73. *Default Options*, *supra* note 19.

74. Frederic S. Mishkin, *How Big a Problem Is Too Big to Fail? A Review of Gary Stern and Ron Feldman's "Too Big to Fail: The Hazards of Bank Bailouts"*, 44 J. ECON. LITERATURE 988, 988–90 (2006) (book review).

75. *Id.* at 994–99.

76. *Id.*

77. *Id.* at 999.

78. Schwarcz, *supra* note 16, at 97–98.

the rest of the world.<sup>79</sup> Therefore, strategies and policies should be adopted to enable an interconnected world to better cope with defaults in order to prevent future international financial failures. With Greece's recent agreement to the biggest sovereign debt restructuring deal ever,<sup>80</sup> this appears an opportune time to analyze and compare debt-restructuring alternatives.

#### A. METHODS OF DEBT-RESTRUCTURING

Restructuring sovereign debt creates problems because the debt agreements are governed by incomplete contracts.<sup>81</sup> These contracts lack provisions for bondholder communication centers, restraints on disruptive litigation, and majority voting structures for changes in the contract's terms.<sup>82</sup> Because adding or changing terms in the contracts usually requires the unanimous consent of all creditors and debtors,<sup>83</sup> the incomplete contracts lead to collective action problems—creditors strategically hold out from agreeing to reasonable deals.<sup>84</sup> By holding out, creditors hope to be allocated more than their fair share of the settlement.<sup>85</sup> However, this approach results in creditors rejecting reasonable restructuring plans.<sup>86</sup> Therefore, “the key to more orderly restructuring is to encourage lenders and borrowers to specify more complete contracts that lay out the procedures for restructuring at the time the debt obligation is incurred.”<sup>87</sup>

Scholars have proposed four potential options for sovereign debt restructuring: (1) creating complete and efficient debt contracts, the free-market approach; (2) creating statutory contracts; (3) unilaterally restructuring debt contracts by debtor governments;<sup>88</sup> and (4) creating an international bankruptcy court.<sup>89</sup> This Note focuses primarily on the free-market and statutory contracts approaches, because the other two

---

79. *Id.*

80. *Greece Reaches Agreement on Biggest Sovereign Restructuring*, NEWSORGANIZER (Feb 21, 2012), available at <http://www.newsorganizer.com/article/greece-reaches-agreement-on-bid4c67a16695257be5a15ddf4d443a99d>.

81. Barry Eichengreen, *Restructuring Sovereign Debt*, 17 J. ECON. PERSP. 75, 83 (2003).

82. *Id.*

83. Schwarcz, *supra* note 16, at 99.

84. *Id.* at 98.

85. *Id.*

86. *See id.*

87. Eichengreen, *supra* note 81, at 83.

88. Schwarcz, *supra* note 16, at 98, 101.

89. Eichengreen, *supra* note 81, at 82.

approaches—unilateral reconstruction and an international bankruptcy court—face significant challenges that make them unviable options<sup>90</sup>

The free-market approach and the statutory approach are the most viable options for sovereign debt restructuring for several reasons. This section will explain both approaches.

### 1. The Free-Market Approach

The free-market approach addresses the holdout problem by advocating for the inclusion of “collective-action clauses” (“CAC”) in debt agreements.<sup>91</sup> CACs attempt to create better communication channels for bondholders and creditors to facilitate discussion.<sup>92</sup> The important CAC provisions are “collective representation, majority enforcement, and majority restructuring.”<sup>93</sup> Collective representation provisions allow bondholders to designate a representative to negotiate with the debtor on their behalf.<sup>94</sup> Majority enforcement clauses try to minimize the frequency of litigation by requiring that a certain fraction of bondholders agree to a lawsuit.<sup>95</sup> Finally, the most important terms introduced by CACs are majority-restructuring clauses. Majority-restructuring clauses alleviate the incomplete contracts problem by specifying the percentage of bondholders needed to change the terms of a contract.<sup>96</sup> Therefore, the free-market approach attempts to provide more complete contracts in debt restructuring agreements by using CACs.

---

90. Countries can always unilaterally restructure debt agreements by refusing to pay debts or by deferring payments and dictating new terms to creditors. Schwarcz, *supra* note 16, at 101. However, unilateral debt restructuring can be problematic for the debtor nation. Unilateral debt restructuring may result in reputational harm and seizure of assets. *Id.* Moreover, this form of restructuring is “merely default cloaked in semantics.” *Id.* at 102. Thus, unilateral debt restructuring fails to effectively protect the global economy from the problems caused by a debtor nation’s default. *Id.*

An international bankruptcy court is also not an ideal way to restructure sovereign debt. Scholars are skeptical of an international bankruptcy court because of its potential to interfere with national law and to weaken creditors’ rights through private debt contracts, which could then create a funding problem for development needs. Eichengreen, *supra* note 81, at 82. Critics warn that a “sovereign bankruptcy court would involve a court pursuing development goals, which is exactly the opposite of what normal bankruptcy courts are supposed to do.” *Id.* The bankruptcy court would affront national sovereignty while pursuing ex ante development goals. *See id.* Therefore, an international bankruptcy court may not be a realistic debt-restructuring alternative.

91. Schwarcz, *supra* note 16, at 99.

92. Eichengreen, *supra* note 81, at 83.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 83–84.

Most debt-restructuring contracts do not contain CACs, so the CACs must be introduced *ex post*. If CACs are not included in the contracts, sovereign debtors can try to replace existing debt with debt governed by CACs—but this can be a lengthy process.<sup>97</sup> CACs may be introduced into contracts by a sovereign debtor through exchange offers with exit consents; that is, debtors can offer creditors the opportunity to exchange their previous contracts with contracts that contain CAC terms.<sup>98</sup> In this sort of agreement, the consenting creditors would be required to forego any agreement for unanimous creditor consent.<sup>99</sup> Additionally, creditors who do not agree to the exchange might be deprived of those protections if a sufficient number of creditors do consent.<sup>100</sup> Even with this coercion, exchange offers are not always successful.<sup>101</sup>

The recent Greek debt-restructuring agreement is an example of a free-market deal, even though some actions were taken unilaterally. According to the IMF, in 2012 Greece launched the world's largest-ever debt-restructuring plan.<sup>102</sup> As part of this plan, Greece asked investors to take a 53.5% loss in the face value of their bonds.<sup>103</sup> Because about 90% of Greece's \$260 billion in privately held bonds did not include CACs, Greece changed its law to include CACs in its debtors' contracts.<sup>104</sup> "Although the debt swap [was] meant to be voluntary, Greek lawmakers in recent days changed the law to require that holdout investors be forced to participate if a majority of investors, representing two-thirds of the outstanding bonds, agree to the exchange."<sup>105</sup> Creditors will swap their longer-dated Greek bonds—worth 31.5% of their holdings—and their

---

97. See Schwarcz, *supra* note 16, at 99–100.

98. *Id.* at 105.

99. *Id.*

100. *Id.*

101. *Id.* at 106. Professor Schwarcz acknowledges that exchange offers have worked in Ukraine, Pakistan, and Ecuador. However, these exchange offers involved small and simple debt structures, so they are not "representative of exchange offers engaged in by larger countries with more debt or more complex debt." *Id.*

102. Howard Schneider, *Greece Posts Debt Offers to Investors on Website*, WASH. POST, Feb. 24, 2012, [http://www.washingtonpost.com/business/economy/greece-posts-debt-offer-to-investors-on-website/2012/02/24/gIQAuMvgYR\\_story.html](http://www.washingtonpost.com/business/economy/greece-posts-debt-offer-to-investors-on-website/2012/02/24/gIQAuMvgYR_story.html).

103. George Georgiopoulos, *Greece Launches Long-Awaited Debt Swap Offer*, REUTERS (Feb. 24, 2012, 5:30 PM), <http://www.reuters.com/article/2012/02/24/us-greece-idUSTRE8120HI20120224> (estimating actual losses to be between 73% and 74%).

104. Schneider, *supra* note 102.

105. *Id.*

short-term paper issued by the European Financial Stability Fund—worth 15% of their old bonds.<sup>106</sup>

The CACs added into Greek law allow for “the exchange [to] go ahead once 50% of bondholders have responded to the offer and the CACs will be activated once two-thirds of that quorum has voted in favor of the swap.”<sup>107</sup> Greece stated that it would go ahead with the swap only if 90% of bondholders participated.<sup>108</sup> If somewhere between 75% and 90% of bondholders participated, Greece would consult its public creditors before deciding whether to move forward.<sup>109</sup> In the end, the Greeks swapped bonds once 75% of the creditors agreed to the CACs.<sup>110</sup> In short, the Greek government introduced CACs into their debt deals *ex post* with a 75% majority requirement.

Currently, the free-market approach is the only approach used to restructure debt deals. The CACs help complete the contracts and get deals done. Sometimes the CACs are part of the contracts *ex ante*, but more often the CACs have to be agreed upon *ex post*. The process of adding CACs to contracts *ex post* is very inefficient and creates uncertainty for borrowers. Additionally, while CACs can provide creditors and debtors with tools to facilitate debt restructuring, these clauses do nothing to solve the underlying problems that lead to the financial problems in the first place.

There is an additional caveat when applying the free-market approach to U.S. debt. Taking such action *ex post* could be seen as violating the Contracts Clause of the Constitution or the Due Process Clause of the Fifth Amendment. However, the changes made to the contract terms during a debt-restructuring would not violate either of these Constitutional provisions. The Contracts Clause provides that “[n]o state shall . . . pass any . . . [l]aw impairing the Obligation of Contracts.”<sup>111</sup> While the passage of an *ex post* contract adjustment—possibly without the unanimous consent of the creditors—would seem to be such an impairment, creditors’ rights are not impaired by *ex post* changes in contract details. An impairment of

---

106. Georgiopoulos, *supra* note 103 (“The debt swap, also known as private sector involvement, is designed to cut Athens’ debt load to 120.5 percent of its gross domestic product by 2020 from 160 percent, in the hope that it would open the way for its eventual return to bond markets.”).

107. *Id.*

108. *Id.*

109. *Id.*

110. Oliver Tree, *Greece Says 75% of Private Creditors Agree to Crucial Bond Swap*, INT’L BUS. TIMES (Mar. 8, 2012, 11:43 AM), <http://www.ibtimes.com/articles/311350/20120308/greece-default-news-deal-bonds-swap.htm>.

111. U.S. CONST. art. I, § 10, cl. 1.

contractual obligations does not violate the Contracts Clause if “the impairment is both reasonable and necessary to fulfill an important public purpose.”<sup>112</sup> Debt-restructuring deals fall within this exception. For example, although the supermajority voting violates dissenting creditors’ rights, the impairments are both reasonable and necessary to protect state financial integrity.<sup>113</sup> Further, sovereign debt restructuring is outside the scope of the Contracts Clause. The Contracts Clause protects contracts from state law impairment; sovereign debt restructuring exclusively involves the federal government.<sup>114</sup>

The Fifth Amendment that provides protection against the federal government impairing contracts.<sup>115</sup> Still, debt-restructuring deals do “not violate the Fifth Amendment because retroactive federal legislation is constitutional so long as it does not constitute a ‘taking’ by completely destroying property rights in a way that the affected parties could not have anticipated.”<sup>116</sup> For example, the supermajority voting does not completely destroy a creditor’s rights; rather, the individual creditor’s right to holdout is destroyed, but the right to holdout is an unreasonable expectation.<sup>117</sup>

## 2. The Statutory Approach

The statutory approach to debt restructuring tries to create an international system that binds creditors and debtors to pre-set contracts as part of an agreement.<sup>118</sup> The statutory approach has been proposed and debated, but no international law implementing it has been put into force.<sup>119</sup> Anne Krueger, deputy director of the IMF, proposed the Sovereign Debt Restructuring Mechanism (“SDRM”).<sup>120</sup> The SDRM’s four main features are: (1) supermajority voting by creditors for amending contract terms; (2) protection for creditors from new private lending to avoid funding problems; (3) restraints on litigation through majority voting; and (4) dispute resolution forums.<sup>121</sup> Through these features, a SDRM is

---

112. Steven L. Schwarcz, *A Minimalist Approach to State “Bankruptcy”*, 59 UCLA L. REV. 322, 336 (2011) (quoting *Seltzer v. Cochrane*, 104 F.3d 234, 236 (9th Cir. 1996)).

113. *Id.* at 337.

114. *Id.*

115. *Id.* at 338.

116. *Id.*

117. *Id.*

118. Eichengreen, *supra* note 81, at 88–89.

119. Schwarcz, *supra* note 16, at 100.

120. *Id.* Another approach to statutory debt-restructuring is the Sovereign Debt Restructuring Convention (“SDRC”). However, due to the similarities in structure between the SDRM and the SDRC, this Note will focus only on the former. *See id.* at 103–04.

121. Eichengreen, *supra* note 81, at 89.

able to address both the collective action problem and the funding problem present in typical debt-restructuring deals.<sup>122</sup>

Like the free-market approach, the SDRM addresses the collective action problem through supermajority voting. However, unlike the free-market approach, under which CACs typically have to be introduced into contracts ex post, the SDRM already has supermajority voting procedures in the contracts ex ante.<sup>123</sup> The supermajority vote is legally binding on dissenting creditors.<sup>124</sup> Given that similarly situated creditors are voting, and any vote binds all creditors, the presumption is that the vote should generally benefit both the supermajority and the dissenters.<sup>125</sup>

The SDRM also provides a solution to the funding problem. The funding problem occurs because “a nation is likely to need to borrow new money to pay critical expenses during the debt restructuring process, but no lender is likely to be willing to lend such funds unless its right to repayment has priority over existing debt claims.”<sup>126</sup> Therefore, the nation gives first priority to new loans so that the nation can pay critical expenses during debt restructuring.<sup>127</sup> This makes existing creditors unhappy because the nation’s new loans now have priority over their existing loans.<sup>128</sup> To deal with this problem, the SDRM protects these existing creditors by requiring that the priority terms for new loans be reasonable.<sup>129</sup> The statutory model also gives existing creditors the power to object to the terms if they are not reasonable.<sup>130</sup> Lastly, the SDRM assumes that once a nation accepts the statutory proposal, both sovereign debtors and creditors are bound by its terms in order to maintain consistency.<sup>131</sup> This reduces the uncertainty that creditors face by ensuring that the terms of the debt-contract will not be changed ex post.

#### B. COMPARING THE FREE-MARKET AND STATUTORY APPROACHES

The two main issues that the free-market and statutory approaches to debt-restructuring must address are the holdout problem and the funding problem. As explained above, the holdout problem arises when creditors

---

122. Schwarcz, *supra* note 16, at 107–08.

123. *Id.* at 107.

124. *Id.*

125. *Id.* at 107–08.

126. *Id.* at 103.

127. *See id.* at 108.

128. *See id.*

129. *See id.*

130. *Id.*

131. *Id.* at 108–09.

refuse to accept the terms of a debt restructuring agreement in order to secure a disproportionate advantage for themselves, relying on their increased leverage. The free-market approach solves the holdout problem *ex post* by introducing CACs into debt contracts that allow the terms of the contract to be modified through supermajority voting, rather than by the unanimous vote of creditors. On the other hand, the statutory approach addresses the holdout problem *ex ante*, by including supermajority voting on sovereign debt-restructuring plans from the beginning. The funding problem arises when a sovereign entity needs funding but cannot attract investors because of its preexisting obligations. The free-market approach does not provide a reliable solution for the funding problem because it relies on contracts and guarantees that do not much security. The statutory approach, however, does provide a solution for the funding problem by allowing new creditors to receive a first priority guarantee on loans given to nations for critical expenses.

#### 1. The Holdout Problem

As mentioned above, the free-market and statutory approaches attempt to solve the holdout problem through CACs and supermajority voting, respectively. While neither option is exemplary, the statutory option arguably solves the holdout problem more efficiently than the free-market approach because it is predictable and, unlike the free-market approach, does not try to change the terms of a debt contract after the contract has been agreed to by the parties.

As explained above, CACs are an inefficient solution to the holdout problem because they introduce uncertainty into the marketplace. Market efficiency can be correlated with investor confidence—uncertain investors lead to an inefficient marketplace.<sup>132</sup> The free-market approach is unpredictable because it leads to different contracts on a case-by-case basis.<sup>133</sup> Parties introduce CACs into contracts in exchange offers with exit consents.<sup>134</sup> These extra contracts and steps increase uncertainty.<sup>135</sup> As discussed earlier, the Greek government acted unilaterally when annexing legislation to include CACs into contracts.<sup>136</sup> The free-market approach

---

132. *Id.* at 109.

133. *Id.* at 106.

134. *See supra* Part II.A.1.

135. *See* Schwarcz, *supra* note 16, at 109–10.

136. Georgiopoulos, *supra* note 103.



might give too much power to countries to act unilaterally, and can lead to different terms, which might at times be unfavorable to creditors.<sup>137</sup>

Additionally, there is no guarantee that debt exchanges will be successful. This increases the uncertainty surrounding CACs. As mentioned early, the examples of successful debt exchanges involved small and simple debts, so it is not certain if CACs will work for large and complex debts.<sup>138</sup> As a result, creditors and debtors might not assume that CACs are eventually going to be included in the contracts, and the possibility that CACs might later be included creates uncertainty.

The statutory model, on the other hand introduces basic supermajority voting from the onset, which leads to common contract terms.<sup>139</sup> Because these terms are included in the contracts *ex ante*, there is not the same uncertainty as presented by the free-market approach. This in turn produces a more efficient marketplace. Additionally, because there is no attempt to change the terms of a preexisting contract, a creditor does not have an opportunity to hold out and to use that leverage to secure an advantage for himself.

Although the statutory option creates more certainty, because the terms are agreed upon *ex ante*, advocates of CACs and the free-market approach have argued that the statutory option gives the debtor nation too much power and could cause transition problems.<sup>140</sup> Advocates of CACs argue that it gives the debtor nation the power to reduce or cancel its debts, and this power might create less incentive for debtor nations to repay their debts.<sup>141</sup> In turn, this power can lead to higher borrowing costs.<sup>142</sup> However, there is no evidence that CACs reduce borrowing costs.<sup>143</sup> Another criticism of the statutory approach is that it could encounter transition problems—if all bonds are required to contain supermajority

---

137. Daniella Strik, *Proposed Greek Collective Action Clauses Law May Trigger Its International Law Obligations*, KLUWER L. INT'L, <http://kluwer.practicesource.com/blog/2012/proposed-greek-collective-action-clauses-law-may-trigger-its-international-law-obligations> (last visited Mar. 18, 2013). Strik argues that, in light of the “coercive nature of the legislation and ‘take-it-or-leave’ it nature of [debt exchanges],” the free-market approach risks breaching the standards of fair trade and equitable treatment.

138. See *supra* note 101 and accompanying text.

139. See *id.* at 109–10.

140. Schwarcz, *supra* note 16, at 110.

141. *Id.*

142. *Id.*

143. *Id.*

clauses, it will take time for the markets to implement these contracts.<sup>144</sup> However, it is unclear if this truly poses a problem because introducing CACs into the market has also taken a significant amount of time.<sup>145</sup>

In conclusion, the statutory approach provides more certainty and efficiency in dealing with incomplete contracts than does the free-market approach.<sup>146</sup> The statutory model creates similar contracts with supermajority voting and eliminates the extra step of adding CACs ex post to agreements.<sup>147</sup>

## 2. The Funding Problem

The free-market approach and the statutory approach both attempt to solve the funding problem by providing a grant of priority to creditors who take on sovereign debt in times of restructuring. However, solving the funding problem through the statutory approach is more likely to be successful because it creates a legally enforceable priority right of repayment whereas under the free-market approach any right of priority is granted through an agreement between the debtor and creditor, and such an agreement is likely to be objected to by existing creditors.

The free-market approach's solution to the funding problem presents uncertainty.<sup>148</sup> Under the free-market approach, debtors can still receive new loans by providing a priority right of repayment through national law or contract.<sup>149</sup> The debtor nation can also grant priority—through an agreement—over objections.<sup>150</sup> However, as mentioned earlier, existing debtors protest new loans that have priority over their own existing loans—the type of contract dictates whether these objections have any significance.<sup>151</sup> Despite these options, it is questionable whether granting priority, absent a statutory right, would be effective or even enforceable.<sup>152</sup> A priority agreement might not be enforceable under applicable national

---

144. Eichengreen, *supra* note 81, at 91 (“The IMF . . . has estimated that if all sovereign bonds issued starting in 2002 include collective action clauses, but no existing bonds are amended or retired, 80 percent of international sovereign bonds would include collective action clauses by 2010 and 90 percent by 2019. . . . How much one should worry about the speed of this transition is unclear. After all, proposals for getting collective action clauses into the market have been debated for at least eight years.”).

145. *See id.*

146. Schwarcz, *supra* note 16, at 109.

147. *See id.* at 110.

148. *Id.* at 112–13.

149. *Id.*

150. *Id.* at 113.

151. *Id.* at 108.

152. *Id.* at 112–13.

laws because there is a risk that a government will amend its laws ex post to allow it to dismiss the priority.<sup>153</sup> Similarly, a priority agreement made through a contract might not be enforceable, either under national or foreign law. If the contract is under national law, there is the same risk that the government will amend its contract laws ex post.<sup>154</sup> If the contract is under foreign law, the debtor nation could breach the contract the same way it breached its debtor agreement.<sup>155</sup> In order to avoid breach, creditors can ask for collateral in return for the new loans, but again, the creditor has no guarantee that the debtor will pay.<sup>156</sup> In theory, debtor nations should fulfill these priority contractual obligations because breaching contracts can create reputational costs for a nation.<sup>157</sup> If a nation breaches its contractual obligations, future creditors will be more hesitant to borrow from the nation, and may demand a higher rate of return to do so.<sup>158</sup> However, it is also possible that the cost of fulfilling contractual obligations may outweigh the costs of reputational harm incurred by breaching those obligations.<sup>159</sup> Even if a debtor nation honors the priority contracts it signs, previous creditors whose contracts were superseded could potentially bring international lawsuits to collect their share of the payments from the new creditors.<sup>160</sup>

On the other hand, the statutory approach directly addresses the funding problem by enabling a sovereign debtor to obtain funding to pay its critical expenses during the debt-restructuring process.<sup>161</sup> In order to obtain new loans to pay off expenses when restructuring debt, sovereign debt holders must offer a priority right of repayment to the new loans,<sup>162</sup> otherwise creditors would not be willing to loan new money to a country already defaulting on its loans.<sup>163</sup> The statutory approach solves the funding problem by granting a legally enforceable priority right of repayment to loans obtained during the restructuring process, subject to reasonableness.<sup>164</sup>

---

153. *Id.* at 113.

154. *Id.*

155. *Id.*

156. *Id.* at 114.

157. *See id.* at 113.

158. *See id.*

159. *Id.*

160. *Id.* at 114.

161. *Id.* at 112.

162. *Id.*

163. *Id.* at 103.

164. *Id.* at 108.

Despite the apparent benefits of the statutory approach, the free-market approach might not be much worse than the statutory approach due to political and economic motivation to fund debtor nations during a debt-restructuring process.<sup>165</sup> While the limitations of the free-market approach make it less appealing for creditors to aid a nation that is in the process of restructuring, regional alliances would probably come to the rescue of countries in need of loans during the restructuring process.<sup>166</sup> In short, the statutory and free-market approaches would likely lead to similar results. The statutory approach proposes a more efficient *ex ante* process, but defining reasonable priority terms would still create difficulties and roadblocks.<sup>167</sup> Even though the free-market approach does provide a consistent and reliable source for funding, the free-market approach's *ex post* funding still leads to the extension of loans during the debt deals due to political and economic motivations.<sup>168</sup>

### 3. Summary

This Note has, thus far, analyzed two debt-restructuring alternatives: the free-market approach and the statutory approach. The free-market approach involves creditors and debtors restructuring debts through CACs.<sup>169</sup> Under the statutory approach, the basic terms of debt restructuring—such as supermajority voting—are already set forth in statute.<sup>170</sup> In the real world marketplace, the absence of a statutory approach has made it difficult to compare the two approaches.<sup>171</sup> It has not been observed how the market place would integrate a statutory process and how long the transition period would actually take.

Theoretically, the statutory approach will create a more efficient market for debt restructuring because it can create a more certain standard for supermajority voting and a solution to the funding problem.<sup>172</sup> In contrast, the free-market approach requires *ex post* negotiations to introduce new terms into the debt contracts, which creates uncertainty and

---

165. *Id.* at 115.

166. This possibility is evidenced by the EU's refusal to allow Greece to default or to withdraw from the EU. *Rehn: EU Won't Let Greece Default, Quit Euro Zone*, NOVINITE.COM (Sept. 22, 2011), [http://www.novinite.com/view\\_news.php?id=132325](http://www.novinite.com/view_news.php?id=132325). ("An uncontrolled default or exit of Greece from the euro zone would cause enormous economic and social damage, not only to Greece but to the European Union as a whole, and have serious spillovers to the world economy.").

167. *See* Schwarcz, *supra* note 16, at 116.

168. *Id.* at 115.

169. *Id.* at 104–05.

170. *Id.* at 107.

171. *Id.* at 116.

172. *Id.* at 109, 112.

in turn, an inefficient market.<sup>173</sup> As observed by Greece's unilateral changes to its national law to introduce CAC terms into contracts, the free-market approach can be exploited, resulting in unfair terms.<sup>174</sup> Further, the free-market approach does not provide a solution for the funding problem—political and economic factors likely lead to a sovereign nation receiving the appropriate funding during the restructuring process.<sup>175</sup> Therefore, it would appear that the statutory option is the best option for debt restructuring because it creates certainty in the marketplace by introducing universal terms through statute and provides a solution to the funding problem.<sup>176</sup>

However, this does not mean that the statutory approach is the perfect option. In fact, it has the potential to create new problems. For example, it is unknown how long it will take to introduce the statutory approach into the marketplace, and, once integrated, it could lead to higher costs for borrowing money.<sup>177</sup> Moreover, the statutory model's solution to the funding problem might not be a solution at all. The reasonable priority terms it introduces into new loans are not defined and it may be difficult to adequately define such terms. Also, the free-market approach has shown that there are many alternative solutions to finding new funding suggesting that the funding problem may not require a statutory solution in the first place. In short, the statutory approach provides only a potentially more efficient approach to the debt-restructuring process.<sup>178</sup>

In addition, an efficient debt-restructuring process alone—regardless of whether it's a free-market or statutory approach—provides only a short-term solution for defaulting nations. CACs and supermajority voting might be effective for debt restructuring, but they might not lead to long-term solutions for an economic crisis. Although debt restructuring might lead to better debt terms for a sovereign government by helping the government pay back its debt and avoid default, it does not help solve the original problems that lead to the potential default in the first place. Debt-restructuring deals do not advance any policy changes that might solve a country's financial problems. With the expectation of protection through debt restructuring, governments can be expected to act according to the TBTF theory. Without requiring the debtor nation to make policy changes

---

173. *See id.* at 109.

174. *See id.* at 106.

175. *See id.* at 116.

176. *Id.*

177. *Id.*

178. *See id.*

in conjunction with the debt restructuring, the government officials will continue to spend money in the same ways that caused the debt, and the initial financial problems will not be resolved.<sup>179</sup> Therefore, in general, debt-restructuring deals need to also provide a solution for a country's long-term financial problems.

As world financial markets become increasingly intertwined, the likelihood that sovereign debt defaults will trigger financial crises increases.<sup>180</sup> The potential for market collapses, in turn, makes most countries TBTF; therefore, creditors will restructure debts, and governments will put together bailout packages to avoid defaults.<sup>181</sup> Because debt-restructuring alternatives are preferred to more costly bailouts, the creation of efficient debt-restructuring processes is intended to minimize the negative impact of inevitable future sovereign defaults.

#### IV. DEBT RESTRUCTURING ALONE MIGHT NOT BE THE SOLUTION

The proposed Greek debt-restructuring deal will potentially lower the Greek debt to 120.5% of its GDP by 2020.<sup>182</sup> Currently, the debt stands at about 152.6% of its GDP.<sup>183</sup> The debt restructuring will help guide Greece through its financial crisis until the global economy picks up.<sup>184</sup> However, debt restructuring alone cannot solve Greece's or the world's future economic problems. In order to provide a more long-term solution, Greece will need bailout packages in addition to the debt restructuring. Even though bailout packages are expensive and risky, the austerity measures in bailout packages will stabilize the Greek economy and help it to avoid bankruptcy in the long run.

In return for numerous bailout packages, the European Union pressured Greece to accept austerity measures.<sup>185</sup> For example, the 2011 austerity measures planned to increase income tax rates, lower the tax-free threshold, increase sales tax, cut 150,000 public-sector jobs, increase the retirement age to sixty-five, and reduce government department budgets.<sup>186</sup>

---

179. See STERN & FELDMAN, *supra* note 16, at 18–19.

180. Schwarcz, *supra* note 16, at 115.

181. See *id.* at 115–16.

182. Georgiopoulos, *supra* note 103.

183. *Euro Area Government Debt Up to 90.0% of GDP*, *supra* note 7.

184. Georgiopoulos, *supra* note 103.

185. *Amid clashes, Greek Parliament approves austerity measures*, CNN (Feb. 12, 2012), <http://www.cnn.com/2012/02/12/world/europe/greece-debt-crisis> [hereinafter *Amid clashes*].

186. Graeme Wearden, *Greece Austerity Plan: What Is Being Voted On*, GUARDIAN (June 29, 2011, 4:57 PM), <http://www.guardian.co.uk/business/2011/jun/29/greece-austerity-plan-what-voted-on>.

The February 2012 austerity measures decreased the minimum wage by 22% (32% for those under twenty-five), reduced monthly pensions above €1300 by 12%, and cut the defense budget by €400 million.<sup>187</sup> Without foreign influence, the Greek government might not have taken these steps to lower spending and increase revenues.<sup>188</sup> Even though these cuts in welfare have severe consequences for Greek citizens in the present and future,<sup>189</sup> these cuts should eventually lead to a more fiscally responsible Greek government.

Cutting benefits and raising taxes are difficult tasks for government officials because the electoral process tends to react negatively to officials who cut social welfare.<sup>190</sup> Implementing severe government budget cuts is even more difficult.<sup>191</sup> In a democracy, such as Greece, where there is a highly competitive political system, fear of electoral punishment restricts the government's ability to implement policy reform.<sup>192</sup> Because of this fear, a government that holds only a small majority of votes is incapable of controlling policy and cutting welfare programs, and is in great danger of being voted out of office over any policy choice that angers the public.<sup>193</sup> The public outrage has been evidence from the austerity measures already passed. For example, riots raged in Greece when the government accepted austerity measures in return for the bailout packages.<sup>194</sup>

Politicians recognize the political backlash they may face if they pass austerity measures. For example, Greek Prime Minister Lucas Papademos and his party “fear[ed] that they [were] essentially being told to commit political suicide to save the country” by accepting the austerity plan

---

187. George Georgiopoulos, *Greece Cuts Minimum Wage as Austerity Drive Begins*, REUTERS (Feb. 28, 2012), <http://www.reuters.com/article/2012/02/28/us-greece-idUSTRE81R1KR20120228>.

188. *See id.*

189. *Amid clashes*, *supra* note 185. *See also* Sarah Butrymowicz, *What Do the Greek Austerity Measures Mean for Education?*, HUFFINGTON POST (Feb. 22, 2012, 12:04 PM), [http://www.huffingtonpost.com/sarah-butrymowicz/what-do-the-greek-austeri\\_b\\_1291810.html](http://www.huffingtonpost.com/sarah-butrymowicz/what-do-the-greek-austeri_b_1291810.html) (discussing the effect austerity measures will have on Greece's education system).

190. Bonoli, *supra* note 23, at 239–245.

191. *See* Niki Kitsantonis & Rachel Donadio, *Greek Parliament Passes Austerity Plan After Riots Rage*, N.Y. TIMES, Feb. 12, 2012, <http://www.nytimes.com/2012/02/13/world/europe/greeks-pessimistic-in-anti-austerity-protests.html>.

192. For a discussion of when a political climate is most likely to dissuade politicians from implementing unpopular reform measures, see Bonoli, *supra* note 23, at 244–45.

193. *Id.* at 240.

194. Kitsantonis & Donadio, *supra* note 191 (the new austerity measures require a 22% cut in minimum wage and 150,000 government layoffs by 2015).

associated with the second bailout package.<sup>195</sup> Thus, politicians may be reluctant to pass austerity measures that will retrench current social policy,<sup>196</sup> even if the changes are actually beneficial to the long-term prospects of the country. Rather, politicians prefer to continue to uphold social policies that please the public.<sup>197</sup> This leads to an increase in government spending as governments increase—instead of decrease—different departments' budgets.<sup>198</sup> Spending might plateau during an economic boom, such as Greece's spending from 2000 to 2005 when the debt-to-GDP ratio stayed around 100%, but once economic growth slows down, spending as compared to debt soars because spending does not decrease.<sup>199</sup> Thus, austerity measures provide an opportunity for a government to decrease the extra spending and stabilize its fiscal budget. Therefore, austerity measures might provide a more effective mechanism compared to the electoral system in helping a government stabilize its fiscal budget.

#### A. ANALYZING GREECE

As discussed earlier, Greece had one of the fastest growing economies in the European Union from 2000 to 2007.<sup>200</sup> Yet, during that period, Greece had significantly higher debt than any other country in the European Union.<sup>201</sup> Even with the economy booming, Greek government officials were unable to significantly lower Greek debt, which suggests the Greek had an inefficient budget.

The Greek debt can be attributed to the government's excessive public spending and tax evasion.<sup>202</sup> Specifically, Greece spends excessive amounts on public worker salaries and benefits, and military administration. For example, Greece provides public workers with fourteen months of pay a year; workers receive a half-month of bonus pay during

---

195. Rachel Donadio, *Greece Puts Off Decision on Austerity Moves Amid a Strike Protesting Them*, N.Y. TIMES, Feb. 7, 2012, <http://www.nytimes.com/2012/02/08/world/europe/greek-workers-strike-against-new-round-of-austerity.html>.

196. Bonoli, *supra* note 23, at 246–47.

197. *Id.*

198. See *FACTBOX-Five Areas of Greek Budget Waste*, REUTERS (Apr. 28, 2010, 2:27 PM), <http://www.reuters.com/article/2010/04/28/greece-waste-idUSLDE63R0QZ20100428> [hereinafter *FACTBOX*]. In one example of wasteful department spending, the Greek government employed a committee for a lake that dried in the 1930s.

199. See generally *id.*

200. TSAKANIKAS, VASSILIADIS & DEMIAN, *supra* note 10.

201. *Id.*

202. James Surowiecki, *Dodger Mania*, NEW YORKER, July 11, 2011, [http://www.newyorker.com/talk/financial/2011/07/11/110711ta\\_talk\\_surowiecki](http://www.newyorker.com/talk/financial/2011/07/11/110711ta_talk_surowiecki).



Easter and another during summer, and full month of bonus pay during Christmas.<sup>203</sup> Additionally, public workers can earn extra bonuses for using a computer, speaking a foreign language, and even arriving at work on time.<sup>204</sup> These bonuses can add anywhere from five to thirteen-hundred euros a month to paychecks.<sup>205</sup> Additionally, foresters get a bonus for working outdoors.<sup>206</sup> Not surprisingly, the Greek government saved €1.7 billion when it trimmed most bonuses by 12% and the Christmas and Easter bonus by 30% as part of its first austerity plan.<sup>207</sup> Moreover, Greek workers enjoy, on average, thirty-seven days of total paid time off a year—twenty-five days of vacation and twelve public holidays, making Greece one of the highest paid-vacation countries in the world.<sup>208</sup> Unmarried and divorced daughters of civil servants are allowed to collect their dead parents' pensions, which costs Greece €50 million annually.<sup>209</sup> In total, Greek pension spending is on pace to rise by 12% of GDP by 2050—a figure that is more than four-times the EU average.<sup>210</sup> Additionally, Greek committees employ about 10,000 people, which costs the government over €20 million a year.<sup>211</sup> Greece also spends a substantial amount of its defense budget on its military's administrative needs. Many countries overspend on their military, but Greece spent 80% of its €6.7 billion defense budget on administrative costs and payments to army staff.<sup>212</sup>

Another major problem in Greece is tax evasion. While other countries also face this problem, tax evasion is so prevalent in Greece that it has been referred to as Greece's "national pastime."<sup>213</sup> It is estimated that Greece has a "shadow economy"—legal business that is conducted "off the books" and out of the reach of tax collections—that accounts for 27.5% of its GDP.<sup>214</sup> Due to the prevalence of tax evasion, Greece spends four times more money than the United States to collect income taxes.<sup>215</sup> In January

---

203. *FACTBOX*, *supra* note 198.

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.*

208. See Michael Schreiber, *Countries with the Most Vacation Time*, MAINSTREET (Jan. 25, 2010), <http://www.mainstreet.com/slideshow/lifestyle/countries-tons-vacation-time>.

209. *Id.*

210. *Id.*

211. *Id.*

212. *FACTBOX*, *supra* note 198.

213. Surowiecki, *supra* note 202.

214. *Id.* It is estimated that the shadow economy in the United States accounts for closer to 9% of the GDP.

215. *Id.*

2012, the Greek government published a list naming 4152 major tax evaders who owe the country a total of €14.877 billion.<sup>216</sup> Despite this list, the chances of actual enforcement are slim. A recent study has shown that “enforcement of the tax laws loosened in the months leading up to elections, because incumbents didn’t want to annoy voters and contributors.”<sup>217</sup> Further, even if tax evasion is detected, cases take seven to ten years to resolve because the Greek court system has a backlog of 300,000 cases.<sup>218</sup> Additionally, the Greek tax code provides many loopholes and exemptions for special interests.<sup>219</sup> For example, multiple professions—such as athletes and singers—are given favorable tax rates, while shipping tycoons pay no tax at all.<sup>220</sup> The flaws in Greece’s tax system suggest that true reform is needed and that spending that keeps Greece on its feet without requiring significant adjustments to the government system will be of no real long-term help.

The prevalence of tax evasion in Greece may be attributed to the citizens’ low tax morale.<sup>221</sup> It has been noted that when citizens trust in a country’s democratic and legal systems, it leads to a significant positive effect on the country’s tax morale—the intrinsic motivation to pay taxes.<sup>222</sup> Therefore, Greek citizens’ very low “tax morale” can most likely be attributed to government officials and the system at-large.<sup>223</sup> The fact that the Greek tax system provides exemptions for many wealthy individuals makes the tax overly regressive, disproportionately shifting the burden to poorer individuals.<sup>224</sup> As a result of the increased tax burden, those individuals are less likely to trust the democratic system, are more like to have a low tax morale and, as a result, are less likely to pay taxes.<sup>225</sup>

Examining the Greek government’s spending and policies, it appears that resolving Greece’s debt issues must start at the government level. The President and the executive cabinet must introduce measures to reduce

---

216. Hara Kouki & Antonis Vradis, *Greece’s Tax-Dodging Crackdown Is a Soap Opera for the People*, THE GUARDIAN (Jan 24, 2012, 11:42 AM), <http://www.guardian.co.uk/commentisfree/2012/jan/24/greece-tax-dodging-crackdown>.

217. Surowiecki, *supra* note 202.

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. Benno Torgler, *Tax Morale and Institutions* 4–5 (CREMA Working Paper No. 2003-09, 2003), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=663686](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=663686).

223. See Surowiecki, *supra* note 202.

224. *Id.*

225. *Id.*

government spending. But, as discussed earlier, the electoral process in Greece disincentivizes politicians from decreasing spending through cuts to social welfare. Similarly, debt-restructuring approaches—such as the free-market approach and the statutory approach—that lack conditions for introducing austerity measures cannot solve a defaulting nation’s long-term debt problems. Rather, these processes might only minimize and delay the short-term effects of a default.

Before this Note discusses reforms to debt restructuring that may provide solutions to long-term financial crises, this Note will briefly analyze the United States’ debt crisis and provide more evidence that long-term solutions are urgently needed.

#### B. HOW A U.S. DEFAULT COULD AFFECT THE WORLD’S FINANCIAL MARKETS

The U.S. debt load might not appear concerning when the United States’ current 104.8% debt-to-GDP ratio is compared to Greece’s 152.6% debt-to-GDP ratio. However, given that the U.S. debt is over \$16.7 trillion,<sup>226</sup> while the Greece’s debt is around \$480 billion,<sup>227</sup> the potential damage a U.S. default could have on the world’s financial markets—compared to a Greek default—becomes apparent. A U.S. default should easily shatter the world’s financial markets.

Unfortunately, notwithstanding an improving economy, studies indicate that medium and long-term projections for the U.S. deficit are troublesome.<sup>228</sup> After 2022, the U.S. deficit and debt-to-GDP ratio are projected to become larger, which will lead to an unsustainable economy.<sup>229</sup> Even though a high debt-to-GDP ratio can be a good thing, it usually is associated with lower economic growth.<sup>230</sup> According to economists Alan Auerbach and William Gale, “[t]he debt-to-GDP ratio will pass its 1946 high of 108.6 percent in the late 2020s under extended policy, and in the late 2040s under the CBO baseline.”<sup>231</sup> The extended policy

---

226. *U.S. National Debt Clock: Real Time*, USDEBTCLOCK.ORG, <http://www.usdebtclock.org> (last visited March 22 2013).

227. *National Debt of Greece*, NATIONAL DEBT CLOCKS <http://www.nationaldebtclocks.org/debtclock/greece> (last visited March 22, 2013).

228. Auerbach & Gale, *supra* note 2, at 1599 (stating that, despite recent improvement, realistic Congressional Budget Office projections show that the medium-term outlook remains troublesome and the long-term outlook remains unsustainable).

229. *Id.*

230. See Carmen M. Reinhart, Vincent R. Reinhart & Kenneth S. Rogoff, *Public Debt Overhangs: Advanced Economy Episodes Since 1800*, 26 J. ECON. PERSP. 69, 75–82 (2012).

231. *Id.*

assumes that the current Congress will act like previous Congresses and will renew expiring tax provisions.<sup>232</sup> The CBO baseline assumes the current Congress will do almost nothing to amend current legislation for the next ten years.<sup>233</sup> This assumes that Congress will allow previous tax provisions like the Bush tax cuts to expire.<sup>234</sup> Under the best case scenario, the CBO baseline, in order to maintain fiscal balance through 2089, there needs to be an increase in taxes or cuts in spending equal to about \$320 billion per year.<sup>235</sup> Therefore, “[u]nder even the most optimistic scenario, the necessary adjustments must be several times the size of those adopted under the recent legislation.”<sup>236</sup> Although the Obama administration has adopted legislation to alleviate the U.S. economic crisis, more drastic steps must be taken.<sup>237</sup> Even if the legislation enacted reduces the federal deficit, “the federal budget outlook would still be unsustainable, primarily because rising entitlement spending is not accompanied by increasing revenues.”<sup>238</sup>

Therefore, the following question remains: How much can the Obama administration cut social welfare without suffering adverse political consequences? Studies provide gloomy evidence regarding the United States’ ability to pass austerity measures through the political process if needed:

Overall, the importance of the accountability effect seems to be stronger in the United States than in most European countries. The United States combines the conditions that enhance the importance of the accountability effect: a bipartisan system in which both parties are equally capable of winning important elections, a single-member constituency electoral system, and, perhaps most crucially, an almost permanent state of electoral campaigning due to the two-year lag between presidential and congressional elections.<sup>239</sup>

In line with this analysis, U.S. presidents will likely implement only measures that will not affect them in the electoral process. Essentially, there is little chance for major reforms, especially during their first terms in office and sometimes even during the second term. Even though the Obama administration’s Taxpayer Reform Act of 2012, passed on January 1, 2013,

---

232. *Id.* at 1598–99.

233. *Id.*

234. *Id.*

235. *Id.* at 1604.

236. *Id.* at 1606.

237. *See id.* at 1605–06.

238. *Id.* at 1606.

239. Bonoli, *supra* note 23, at 245.

was billed as a victory for the middle class,<sup>240</sup> it was full of compromises.<sup>241</sup> There was no major unprecedented reform; instead the Obama administration simply canceled previous tax cuts and restored previous tax rates.<sup>242</sup> Even though taxes were increased, the major provisions were allowing the payroll tax reductions from the Bush administration to expire and raising the highest income rate to the same rate as during the Clinton administration but at a higher threshold.<sup>243</sup> Furthermore, most of the revenue from the Taxpayer Reform Act of 2012 is from the expiring of the payroll taxes, which affects the middle and lower classes more than the upper class.<sup>244</sup>

One measure that reflects the difficulty of imposing budgetary reform through a publically accountable branch of the government is the federal debt ceiling. The U.S. government created the federal debt ceiling in 1917 to hold the president fiscally responsible when funding World War I.<sup>245</sup> Although the debt ceiling was created to limit U.S. borrowing, the debt ceiling has been raised seventy-eight times over the past half century.<sup>246</sup> Despite the apparent ineffectuality of the debt ceiling, in 2011 the U.S. government agree to decrease spending by \$2.1 trillion over the next ten years in order to raise the debt ceiling.<sup>247</sup> At face value, these measures seem successful because the government was forced to decrease spending when it otherwise would not.<sup>248</sup> Thus, it appears that the government was able to pass austerity measures through the political process.

Yet, due to the influence of electoral processes, only \$21 billion of the proposed \$2.1 trillion will actually be cut from the budget in 2012.<sup>249</sup> The remainder of the cuts were not scheduled to go into effect until after the 2012 election cycle, at which point Congress could chose to rewrite the

---

240. *Fact Sheet: The Tax Agreement: A Victory for Middle-Class Families and the Economy*, WHITE HOUSE (Jan. 1, 2013), <http://www.whitehouse.gov/the-press-office/2013/01/01/fact-sheet-tax-agreement-victory-middle-class-families-and-economy>.

241. Matt Smith, *Obama Signs Bill Warding Off Fiscal Cliff*, CNN (Jan. 3, 2013), <http://www.cnn.com/2013/01/02/politics/fiscal-cliff>.

242. *Id.*

243. *Id.*

244. *See Id.*

245. Richard Peach, *The Evolution of the Federal Budget and Fiscal Rules* (Feb. 1, 2001) (unpublished manuscript) available at <http://ssrn.com/abstract=2094470>.

246. Wolf, *supra* note 6.

247. *See* David Lauter, *Debt Ceiling Deal Accomplishes Little*, L.A. TIMES, Aug. 1, 2011, <http://articles.latimes.com/2011/aug/01/nation/la-na-debt-assess-20110802>.

248. *See id.*

249. *Id.*

plan.<sup>250</sup> In short, the debt ceiling deal only acknowledged the fiscal problem, and it postponed an ultimate solution until after the election, further proving that the electoral process affects the actions of politicians—specifically, their willingness to pass much-needed austerity measures.

The U.S. debt crisis—and the futility of the government’s attempts to solve it—suggests that any viable debt restructuring plan should include the enforcement of policy conditions on the federal government and should provide a more efficient and comprehensive debt-restructuring process. The enforced austerity measures could potentially reduce the tendency that political officials have of entrenching social policies, and could help provide long-term solutions to financial crises.

## V. THE IMPORTANCE OF AUSTERITY MEASURES AND A PROPOSAL

In addition to focusing on efficiency, the debt-restructuring process should also focus on providing sovereign debtors with austerity measures—to help resolve a country’s financial problems over the long run. An efficient debt-restructuring process without austerity measures will undoubtedly help avert a financial crisis, but it will provide only a short-term resolution to a deeper debt issue. The deeper debt issue will remain unresolved until the government figures out how to balance its budget by significantly reducing its debt. As discussed above, politicians and governments are generally not inclined to introduce austerity measures, such as tax increases or welfare cuts, that could benefit the country in the long run. However, the debt-restructuring process provides an opportunity to introduce these much needed policy changes.

### A. OTHER WAYS TO IMPOSE AUSTERITY MEASURES

So far, conditional austerity packages and changes to policy have been used exclusively during bailouts<sup>251</sup> and IMF funding.<sup>252</sup> For example, the Greek government passed austerity measures in return for bailout packages.<sup>253</sup> While bailout packages are the principal means by which nations implement policy changes, bailout packages are less preferred and more costly than debt restructuring.<sup>254</sup> It is true that the Greek bailouts were needed to prevent Greece from defaulting and that the bailouts

---

250. *Id.*

251. *See Greece, supra* note 9.

252. *See* HORNBECK, *supra* note 27, at 5.

253. *See supra* notes 186–89 and accompanying text.

254. *See supra* Part I.

introduced much-needed austerity measures, but granting more loans to a government that has shown signs of having a unsustainable economy is a concern. For example, as mentioned earlier, even during its economic boom from 2000 to 2007, Greece was unable to substantially lower its debt-to-GDP ratio. Also, while bailouts might introduce much needed austerity measures, they tend to add additional debt to governments, which is what got the governments in trouble in the first place.<sup>255</sup> Therefore, bailouts are less-preferred alternatives to debt restructuring.

An alternative method for introducing policy changes is through the IMF, which mostly exerts its influence by providing emergency funding subject to a nation's commitment to change policies.<sup>256</sup> Generally speaking, "without IMF leverage, a debt workout is unlikely."<sup>257</sup> The IMF sets the necessary policy framework for debtor nations' economic recovery before bondholders begin discussions for debt restructuring.<sup>258</sup> However, the initial policy framework established by the IMF is not always perfect, as was seen during the Argentinean debt restructuring in the early 2000s.<sup>259</sup> The IMF lent too much money to Argentina, which led to a delay of its debt-restructuring process.<sup>260</sup> This delay, in turn, led to an untenable situation: IMF-lending received priority over creditors, which made it undesirable for other financial institutions to help Argentina.<sup>261</sup> Moreover, the IMF was unable to persuade Argentina to negotiate a consensual agreement with its creditors.<sup>262</sup> In conclusion, even though the IMF was able to help with the ultimate debt restructuring and introduction of austerity measures, it delayed the process and it acted as another creditor with competing interests with the original creditors.<sup>263</sup>

Even though both bailout packages and the IMF pressure governments into accepting austerity measures, both methods are riddled with inefficiencies. Bailout packages increase the already unsustainable debt these governments' own, while the IMF acts as an unwanted competitor with the already present creditors because it usually receives priority on its loans.

---

255. See Glaeser, *supra* note 30.

256. HORNBECK, *supra* note 27, at 5.

257. *Id.* at 11.

258. *Id.* at 7.

259. *See id.*

260. *Id.* at 14.

261. *Id.*

262. *Id.*

263. *See id.*

B. A DEBT-RESTRUCTURING PROCESS CAPABLE OF ENFORCING  
AUSTERITY MEASURES

Debt-restructuring deals would be more efficient and beneficial if, instead of waiting for the IMF to impose austerity measures, the deals were implemented with the condition that debtor governments pass austerity measures. Regardless of whether the debt-restructuring deals used the statutory or free-market approach, implementing austerity measures would benefit governments' fiscal budget in the long run. Like bailout packages, debt-restructuring deals should be conditioned on governments passing austerity measures. Both the statutory and free-market approaches should make debt-restructuring deals conditional on the debtor government passing austerity measures. Ideally, the statutory approach will create a more efficient market for debt restructuring because it can create a more certain standard for supermajority voting and a solution to the funding problem. However, the statutory approach has not been implemented in the real world. Thus, even if debt-restructuring deals continue to be negotiated under the free-market approach, they should be conditioned on policy changes that would lead to a balanced budget.

The debt-restructuring deals should contain austerity measures with straightforward terms for the debtor government to accept. Essentially, the debt-restructuring deals would require the debtor government to accept austerity measures its politicians likely would not otherwise be willing to implement—due to fear of losing their positions. In order to create a balanced budget, the austerity measures would deal with the problems underlying the debtor nation's deficit.

While the exact austerity measures that would be included in any restructuring deal would vary from country to country, austerity measures would focus on tax increases and government spending cuts.<sup>264</sup> Austerity measures would focus on these two things because increasing taxes and decreasing spending have proven to be too difficult for most democracies to do on their own. The IMF would govern the austerity packages, and it would need to approve them for reasonableness.

Further, introducing austerity measures *ex post*, as part of debt-restructuring deals, does not interfere with countries' national sovereignty. The debt-restructuring agreements are conditioned on a country willing to accept austerity measures. Therefore, governments would introduce these

---

264. Defining the exact austerity measures is beyond the scope of this Note, which focuses more of the need for austerity measures being part of debt-restructuring deals.



measures in order to have the opportunity to restructure debt and would not agree to deals ex ante with austerity measures already in place. Sovereignty issues would only arise during foreign monitoring—inspection into whether the debtor government is making good on its pledges.

Moreover, similar to the IMF, which creates leverage by providing emergency funding, bondholders already have that leverage to negotiate and set up the debt-restructuring deals. Bondholders' leverage comes through emergency funding provided to debtor governments, so that the governments are able to pay critical expenses and through the U.S. court system. As explained earlier, when governments have emergency financial needs during the debt-restructuring process, providing funding gives the creditors leverage under both the statutory and free-market approach because of the option not to lend.<sup>265</sup>

Further, United States courts have shown a commitment to upholding international contracts, which provides leverage to creditors in executing the terms of such contracts.<sup>266</sup> For example, in *Allied Bank International v. Banco Credito Agricola de Cartago*, summary judgment was granted in favor of a creditor who refused to join a debt-restructuring agreement between Costa Rican banks and other creditors because the loan was clearly due and payable.<sup>267</sup> This was in spite of Costa Rica's unilateral suspension of debt payments to creditors.<sup>268</sup> The court had jurisdiction to hear the case because the contract was made under American law and because Costa Rica's actions were inconsistent with the orderly resolution of international debt problems.<sup>269</sup> In issuing this ruling, Judge Meskill held that "[w]ith respect to private debt, support for the IMF resolution strategy is consistent with both the policy aims and best interests of the United States."<sup>270</sup> The fact that U.S. courts generally uphold the contract terms of debt agreements provides enforceability and credibility, due to the United States' position and influence as a world power, to proposed austerity measures.

This Note leaves open the question of how exactly these austerity measures would be implemented. The austerity measures would either have to be implemented as part of the CACs in the free-market approach, or as

---

265. HORNBECK, *supra* note 27, at 14.

266. Schwarz, *supra* note 16, at 98.

267. *Allied Bank Int'l v. Banco Credito Agricola de Cartago*, 757 F.2d 516, 519 (2d Cir. 1985).

268. *Id.* at 522–23.

269. *Id.* at 521–22.

270. *Id.* at 522.

one of the requirements in the statutory approach. The details of the exact statutory measures and who would enforce them are beyond the scope of this Note.

## VI. CONCLUSION

This Note discussed the importance of a more efficient and comprehensive debt-restructuring process in order to help avert future financial disasters. As global economic struggles continue, more and more countries' financial weaknesses are being exposed.<sup>271</sup> Yet, in a globalized financial world, countries and creditors are not likely to allow nations to default because they have become too big to fail. Countries fear that if other countries default, financial markets will cease to work efficiently, which will have negative consequences on the world financial markets. Therefore, having efficient debt-restructuring processes is crucial. Although world markets currently use a free-market approach for debt restructuring, a statutory approach should be used, because it provides a solution for both the holdout problem and the funding problem. Specifically, the statutory approach solves the holdout problem efficiently by including supermajority voting requirements in contracts and solves the funding problem by requiring priority terms in new loans to be reasonable.

This Note also argued that even though a statutory model, such as SDRM, would help create a more efficient process, it would solve only the short-term problem, while leaving larger systemic problems unsolved. A statutory model would help efficiently provide restructuring debt, but the long-term financial problems associated with countries' economies would go unsolved. Due to politicians' fear of not being re-elected, most governments are unable to propose the mandatory welfare cuts or tax increases that will help solve their financial crises in the long term. Currently, austerity measures are implemented either through bailouts or the IMF; however, bailouts are an undesirable and expensive alternative to debt-restructuring agreements and the IMF process is inefficient. As evidenced by the struggles of Greece and the United States, a better alternative, which will require governments to implement austerity measures, is needed.

This Note proposes that the financial marketplace should implement statutory debt-restructuring deals and that these debt deals should include clauses that allow for debt restructuring conditioned upon governments

---

271. David Lynch, *Global Financial Crisis May Hit Hardest Outside of U.S.*, USA TODAY, Oct. 30, 2008, [http://usatoday30.usatoday.com/money/economy/2008-10-29-global-financial-crisis\\_N.htm](http://usatoday30.usatoday.com/money/economy/2008-10-29-global-financial-crisis_N.htm).

2013]

*Managing Sovereign Debt*

419

passing austerity measures. The debt-restructuring process should only begin after the debtor government passes austerity measures. Even if debt-restructuring deals continue to use the free-market approach, such deals should still include clauses requiring governments to pass austerity measures. The austerity measures should include tax increases and budget cuts that will enable the governments to increase revenue and decrease spending. This would help solve the long-term budget problems that many countries face, because a more balanced fiscal budget would allow the debtor governments to pay off their loans and not default.

