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EUROPE AND THE IMF: *NEC SINE TE, NEC TECUM…*[1]

Fabrizio Balassone[2] *and Marco Committeri*[3]

Abstract

As the sovereign debt crisis burst in 2010, the European Union lacked both the instruments and the expertise to manage the situation. It thus resorted to the International monetary fund. Fund arrangements with euro area countries would not have been possible without changing the existing lending rules. Those changes provided the margins of flexibility needed to gain time and address systemic stress and heightened uncertainty. While seen by some as "a favour" to Europe, the changes introduced may well prove quintessential in tackling future crises in other regions of the world: repealing or modifying the amendments would not be desirable now. The exposure of significant gaps in Europe's institutional setting solicited deep reforms. Five years into the crisis European economic governance is much stronger, and institutions and procedures for crisis management are in place and operating. It seems that the EU and the euro area would be less in need of external help should they be confronted with new crises in the future. However, some excess rigidity remains in the mechanism governing the provision of financial support and the euro continues to be a "money without a state".

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Introduction

Sovereign debt crises in the euro area exposed relevant gaps and solicited major changes in Europe's institutional setting, especially in the fields of economic surveillance and crisis management. Those reforms did not proceed in a smooth and linear manner, though; the process evolved under the pressure of events, and in ways that often failed to send appropriately reassuring signals to market participants – which made the resolution of the crises more costly than could have been.

Importantly, the management of these crises has been accompanied by bitter disputes with Europe's main partners, both advanced and emerging market countries. These controversies relate to the role of Europe in the International monetary fund (IMF), and touch on three key aspects of the Fund's functioning: the

[1] … *vivere possum* (Publius Ovidius Naso, Amores, III, II, 39). The views expressed in this study are solely those of the authors and do not in any way involve the responsibility of the institutions to which they belong. We are grateful to Pietro Catte, Carlo Cottarelli, Giuseppe Parigi, Fabrizio Saccomanni and Paolo Sestito for their valuable comments on earlier versions of this paper.

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criteria for granting financial assistance to its members; the design of its rescue packages; and the perceived legitimacy of the IMF, which is closely linked to its governance mechanisms.

Europe has been held responsible for a substantive weakening of the Fund's Exceptional Access Policy (EAP), i.e. the criteria for granting large-scale IMF loans compared to countries' quotas—with the inclusion of a new "systemic clause" to justify the first Greek program. The subsequent application of the clause to the arrangements with Ireland and Portugal allowed the share of Fund resources deployed in favour of countries of the euro area to soar to roughly one half of total outstanding credit[4]. This raised the legitimate fear on the part of emerging market and developing countries to be crowded out by the Europeans. Some major partners refused participation in a new round of bilateral borrowing agreements with the Fund, with the argument that the euro area should not weigh any further on IMF finances, having sufficient resources on its own to cope with new internal crises.

Criticisms were also directed to the programs designed and managed by the so-called Troika (the IMF, European Commission, and ECB), especially for Greece. *Ex post*, the IMF itself acknowledged that baseline projections were too optimistic and the need for debt restructuring underestimated (IMF 2013b). As a result (and also because of delays and resistance in the implementation of the structural reforms accompanying the program), the country is still in need of continued official assistance.[5] In the perceptions of many, Europe played a key role in designing the program (and determining its flaws), thanks to its massive financial support to Greece and its strong voice in the Fund.

Against this background, the paper asks three main questions, which are addressed in the remaining sections of this note:

- Could the European Union (EU) and euro area (EA) have done without the IMF's help in managing the 2010 crises?
- Have IMF rules been amended to the exclusive benefit of EA countries? Can these amendments be justified by more general considerations? Should they be repealed or modified?
- Could the EU and EA do without the IMF in dealing with possible future crises?

Our main conclusions are the following:

a) Europe could not have done without the IMF at the time of the Greek crisis. Europe was in the awkward position of lacking any crisis management tools. The enforceability of a "European solution" was not fully credible given the poor compliance record of member states with the fiscal rules in the Stability and Growth Pact (SGP). In a context where concerns over moral hazard were paramount, the participation of the IMF, with its expertise in the definition and implementation of macroeconomic programs backing financial assistance to sovereign states, became a necessary condition for reaching an agreement on the first "Greek program".

b) Fund arrangements with EA countries would not have been possible without changing the existing lending rules, but those rules were never meant to be immutable—all IMF policies can be determined with a simple majority of votes cast. The systemic clause provided the margins of

[4] IMF credit to euro area countries also includes a loan of almost SDR900 million to Cyprus, which was approved in May 2013 without invoking the systemic clause.

[5] As we write, negotiations between Greece and the Eurogroup on a further extension of the macroeconomic adjustment program have been ongoing for about four months.

flexibility needed to gain time and address systemic stress and heightened uncertainty; besides, it was meant to apply to all Fund members, not only European ones. The cases of Ireland and Portugal may be considered success stories. This same flexibility may prove quintessential to address future crises in other systemically relevant countries. Repealing or modifying the amendments would not be desirable at this juncture.

c) Five years into the sovereign debt crisis, the institutional landscape of the EU and the EA has deeply changed. Institutions and procedures for crisis management are now in place. Significant expertise has been gained in the definition and implementation of macroeconomic adjustment programs. Stronger surveillance mechanisms (on fiscal, macroeconomic and banking matters) have been introduced to reduce the probability of new crises. Some excess rigidity remains in the mechanism governing the provision of financial support to countries in distress (the Treaty establishing the European Stability Mechanism requires unanimity—or a qualified majority of 85 percent—for decisions concerning financial support and provides for the active participation of the IMF to be sought "wherever possible"). Nevertheless, Europe now appears to be less in need of external help in managing possible new sovereign crises.

Both the IMF and Europe are left with important issues to resolve. The explicit recognition of systemic risks in the Fund's lending policy raises the problem of finding adequate resources. Upgrading the Fund's financial firepower will require significant institutional engineering, whether it is done by increasing its permanent resources (i.e., its quotas), or by enhancing its ability to quickly mobilize additional resources on a temporary basis, including through regional arrangements. European institutions are now called to walk a thin line between preserving the credibility of the rules agreed upon and applying them wisely, taking into due account the specific circumstances of each member state and of the EA as a whole. That said, the main issue remains the need to complement the single currency with a federal budget, a point that was stressed since the early discussions of the monetary union project in the early seventies of the last century.

1. How the IMF got involved in the Greek crisis

When a number of countries decide to share the same currency while retaining fiscal autonomy, financial stability takes up the features of a public good. Sound fiscal policy is a precondition for financial stability, but profligate governments face a less steep interest rate schedule than they would under flexible exchange rates. Therefore, there is an incentive for each government exploit the benefits accruing from the fiscal discipline of others without contributing with their own. Hence the need for discipline-inducing mechanisms.

The solution adopted in the EA was based on a delicate balance between market incentives and rules of conduct. Competition within the single market was supposed to ensure the economic convergence of the member countries and to provide incentives for the necessary structural reforms at national level. Rules of conduct were expected to guarantee prudent budgetary policies since market discipline was not trusted to be sufficient: "the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive" (Delors Report, 1989). The provisions of the SGP were supposed to prevent countries from

borrowing excessively; the "no bail-out clause" in the Treaty of Maastricht was supposed to make it clear that the responsibility for government debt would remain national.[6]

In practice, economic convergence was slow and difficult (in some cases the gaps actually widened) and fiscal rules were not always respected. Later events would prove that too much faith was placed in the "no bail-out clause". For a long time financial markets underestimated sovereign risks: until the outbreak of the crisis the spreads between government bond yields within the EA were close to zero, which suggests that markets were counting on political pragmatism to prevail over a strict interpretation of the "no bail-out clause" in the face of a systemic threat to financial stability.

When the crisis came in late 2009, after the revelation of the true conditions of the Greek public finances,[7] the European response was first to ensure that the Greek authorities would submit a plan to bring the deficit below the 3 percent of GDP threshold, in line with the procedures foreseen in the SGP. Financial assistance was out of the question: it was ruled out by the "no bail-out clause".[8]

Only in April 2010, as the terms at which Greece was able to access capital markets rapidly deteriorated, an agreement was reached and negotiations were started by the Commission, in liaison with the ECB, with the IMF and the Greek authorities on a program of assistance involving a majority of European financing (in the form of coordinated bilateral loans) and substantial IMF financing.[9] Even then, though, the authorities were keen to specify that such mechanism was to be considered as an *ultima ratio*, and the corresponding interest rates would be non-concessional (so as to be in full consistency with the Treaty framework).[10] Although cooperation between European institutions and the IMF was not a novelty,[11] this was the first time that a member of the EA was involved.

[6] Art. 125 of the Treaty on the functioning of the European Union: "1. The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. 2. The Council, on a proposal from the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article."

[7] As required under the SGP, fiscal data and projections were sent by the Greek authorities to the EU Commission on 2 October 2009, before the early general elections to be held on 4 October. These indicated that the general government deficit amounted to 5 percent of gross domestic product (GDP) in 2008 and was expected to decline to 3.7 percent in 2010. On 21 October, a revised report was sent indicating that the actual deficit for 2008 was 7.7 percent of GDP and the expected deficit for 2009 was 12.5 per cent (European Commission, 2010).

[8] See, for instance, the remarks by German Chancellor, Ms Angela Merkel to the effect that "Greece must accept its responsibility for reform" at a press conference on 11 December 2009 following a European Council summit (Jones, 2010).

[9] EA member states first announced their willingness to provide financial assistance to Greece at the Spring European Council of 25-26 March 2010. The agreement was then reached on 11 April 2010. The first tranche of the loan was paid out in May 2010.

[10] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113684.pdf

[11] In October 2008 Hungary requested a Stand-by Agreement (SBA) from the IMF after it had consulted the EU. The EU agreed and joined the IMF in providing Hungary additional financial support using its Balance of Payments Assistance Facility. In December 2008 the IMF approved another SBA with Latvia, in connection with an adjustment program that was jointly elaborated with the EU and representatives from the ECB, Sweden and other Nordic countries. In March 2009 the IMF granted a € 13 billion loan under an SBA to Romania (in addition to financial assistance through the EU, the World Bank, the European Bank for Reconstruction and Development and other international institutions).

The participation of the IMF in the program was not uncontroversial. At a press conference on 4 March 2010, after a meeting of the Governing Council, the then President of the ECB, Jean Claude Trichet noted: "I do not believe that it would be appropriate to introduce the IMF as a supplier of help through standby arrangements or through any such kind of help. […] The fact is that the conditionality inside the euro area has to be decided, in our opinion, by the peers, according to the Stability and Growth Pact and the European framework as it functions".[12]

Even after IMF involvement was finally agreed upon, the need to clarify the "European leadership" in the program was strong. This is evident in the statement by the then President of the European Commission, Manuel Barroso on 25 March 2010: "We have solved this in the European family, in the euro area. This is the European coordinated approach with the participation of the IMF. I think that is the right decision at this time to face what is an exceptional problem that we have in one of our Member States and member of the euro area, considering also the implications it could have for the stability of our economic and monetary union. As we had advocated, the triggering of the mechanism and the implementation of conditionality is to be carried out by the EU institutions".[13]

Europe was in the awkward position of lacking any crisis management tools. Even those opposing a financial role for the IMF recognized its superior expertise in the definition and implementation of macroeconomic programs backing financial assistance to sovereign states.[14] Moreover, the credibility of a fully "European solution" was weak given the poor compliance record of member states with the SGP. Concerns over moral hazard made IMF participation a condition for reaching an agreement on the first "Greek program" (Seitz and Jost, 2012).

2. Bending IMF rules?

To better assess whether and how IMF rules were manipulated in Europe's favour, it is instructive to briefly recall the genesis of those rules and the ideas that led to their approval.

Since as early as the Mexican crisis of 1994-1995 and until the Greek crisis, the IMF had been engaged in laborious discussions of its lending toolkit and policies (see Committeri and Spadafora, 2013, for a review). A landmark step of that process was the so-called "Prague Framework", agreed at the IMF-World Bank annual meetings in September 2000, which hinged on three pivotal ideas–essentially inspired by the experience with emerging market countries, then the main clients of the IMF. First, Fund resources were to remain *limited* and had to be *used sparingly* in order to contain risks of moral hazard. Second, in order to solicit greater discipline by both sovereign borrowers and market participants, exceptional IMF lending had to be made *more predictable*, with greater emphasis being placed on the sustainability of countries' public

[12] (http://www.ecb.europa.eu/press/pressconf/2010/html/is100304.en.html).

[13] http://europa.eu/rapid/press-release_SPEECH-10-132_en.htm?locale=en

[14] While opposing the financial involvement of the IMF (and the related decision-making power), Mr. Trichet recognized that "the IMF's contribution has been important. I mention the fact that we had experts in Athens with the European Commission and with the IMF. And when Commissioner Olli Rehn and Jürgen Stark were in Athens at the beginning of this week, colleagues from the IMF were also present. So the IMF's technical assistance is very important, very much appreciated. And we had very good cooperation" (http://www.ecb.europa.eu/press/pressconf/2010/html/is100304.en.html). See also the discussions in, for instance, Henning (2011), Seitz and Jost (2012), and Pisani-Ferry *et al*. (2013).

debt.[15] Finally, in those cases where a sovereign debt restructuring (SDR) was truly necessary, ways had to be found to involve private creditors and contain the related workout costs.

These ideas were mutually reinforcing, and represented the pillars of a unified strategy aimed at addressing the three main policy dimensions of sovereign debt crises (prevention, management, and resolution). The strategy began to take shape in 2002-2003, with the approval of the IMF's "Exceptional Access Policy (EAP) in Capital Account Crises" and the formal adoption of the so-called "contractual approach" to sovereign debt restructuring, based on the inclusion of appropriate covenants in sovereign bond contracts ("collective action clauses", CACs). According to the new EAP, four criteria were to be met for exceptional financing to be granted: (a) the existence of balance of payments pressures resulting in a financing need beyond normal access limits to Fund resources; (b) indications (based on a "rigorous and systematic analysis") that debt remained "sustainable with high probability" over the program horizon; (c) the expectation of (re-)entering private capital markets over the same horizon; and (d) the definition of a strong adjustment program coupled with institutional and political capacity to deliver that adjustment.

One of the key merits of the new policy was to provide a more rigorous procedure for IMF lending decisions, and a convenient means for communicating these decisions to the general public. Although such analyses would still have to rely on manifestly judgmental elements,[16] the strategy was an attempt to narrow down the scope of the "exceptional circumstances clause" (ECC) embedded in the Fund's internal regulations, which had been frequently invoked to approve large-scale packages following the Mexican crisis, and in conditions of heightened uncertainty about debt sustainability.[17] However, application of the ECC was not formally conditioned to the four EAP criteria.

The IMF's lending framework was further amended after the eruption of the global financial crisis. In March 2009 the Fund approved a major overhaul of its lending armoury. The scope of the EAP was broadened to cover cases of non-capital account crises (i.e., current account ones), as well as all types of balance of payments needs (actual and potential).[18] Importantly, it was agreed that the ECC could be invoked only when the four EAP criteria were met (IMF, 2014c, pp. 470), thereby further reducing the room for discretion allowed by that clause. In April 2009, given the systemic nature of the crisis and the consequent expectation of a fast-growing demand for Fund loans, the G-20 leaders agreed on a tripling of IMF financial resources (from USD250 billion to USD750 billion) and on an extraordinary allocation of Special Drawing

[15] This idea was sketched in the original statement of the International Monetary and Financial Committee of the Board of Governors of the IMF (IMFC), and developed more thoroughly in the following months. In that context, IMFC members agreed that "reliance on the catalytic approach [to IMF financing] at high levels of access [presumed] substantial justification" (IMFC, 2000, para. 22).

[16] Such as those relating to the country's capacity to adjust and return to private capital markets.

[17] The ECC stated that: "the Fund may approve stand-by or extended arrangements that provide for amounts in excess of [normal] access limits in exceptional circumstances". See Executive Board Decision No. 7600-(84/3), January 6, 1984. The nature of these circumstances was left deliberately unspecified, reflecting the inherent difficulty to define them ex ante (IMF 2001).

[18] Besides changes to the EAP, the overhaul also included: (a) the introduction of new "precautionary" facilities such as the FCL, reserved to countries with sound policies and fundamentals potentially exposed to adverse external developments; (b) a rationalization of the remaining facilities; and (c) the doubling of ordinary access limits to Fund resources.

Rights (Group of Twenty, 2009).[19] The move was successful in abating the growing interest rate spreads faced by several emerging market countries.

These developments created the impression of having established a reasonably comprehensive framework for IMF lending, endowed with enough resources to cope with crises, and with an appropriate mix of constraints (the EAP criteria) and discretion (in applying such criteria in concrete circumstances, and assessing whether a sovereign debt restructuring was ultimately required). Yet, the framework in question was certainly not written in the stone: like all other Fund policies it could be amended by simple majority vote. Importantly, progress on the crisis resolution's front has remained uneven in the following years, thereby casting doubts on whether sovereign debt defaults or restructurings could be generally made more predictable and less costly, a crucial condition for the Fund to credibly abide by its newly established lending rules (see Appendix). All in all, it is fair to conclude that in the foreseeable future sovereign debt restructurings will remain an eminently *ad hoc* exercise, relying on a variety of instruments to be combined on a case-by-case basis.

The Greek crisis posed a number of unexpected challenges to the Fund. First, the financing needs of Greece were extremely large by historical standards, and could not be easily accommodated by the IMF alone. Second, the very fear of systemic repercussions in the EA barred the way to a pre-emptive restructuring of Greek debt held by private creditors, thereby exacerbating the burden of the necessary policy adjustment for that country (see Box). Finally, even taking that adjustment into account, Fund staff could only argue that, on balance, the country's debt was sustainable over the medium term, but it was difficult to state categorically that this was the case with a high probability.

As noted earlier, the response to these challenges was a joint EU-IMF rescue package (mostly financed by Europe), which was approved in light of the "high risk of international systemic spill-over effects" raised by a disorderly resolution of that crisis. The debt sustainability criterion of the EAP was amended accordingly, by adding a "systemic clause" that allowed large-scale financing in those cases where: (a) countries' debt could be regarded as sustainable but not with a high probability; (b) there was a high risk of international systemic spill-overs, with (c) all the remaining EAP criteria being met.

Other high-access packages were subsequently approved based on this clause: for Ireland (December 16, 2010), Portugal (May 20, 2011), and once again for Greece (March 15, 2012). In hindsight, the introduction of the systemic clause provided the margins of flexibility needed to gain time and address situations of systemic stress and heightened uncertainty.[20] *Ex ante*, none of these countries would have passed the debt sustainability test with high probability; *ex post*, at least two of them (Ireland and, to a lesser extent, Portugal) were brought back again on to a sustainable path thanks to the EU-IMF arrangements.

[19] The tripling was implemented in several step: first, the IMF launched a campaign to borrow new temporary resources from official bilateral creditors; these resources were subsequently folded in the New Arrangements to Borrow (NAB); finally, a decision was taken to roll back the additional NAB resources into countries' quota subscriptions—a decision that has not yet entered into force pending the US Congress' ratification of the Quota and Governance reforms approved in 2010.

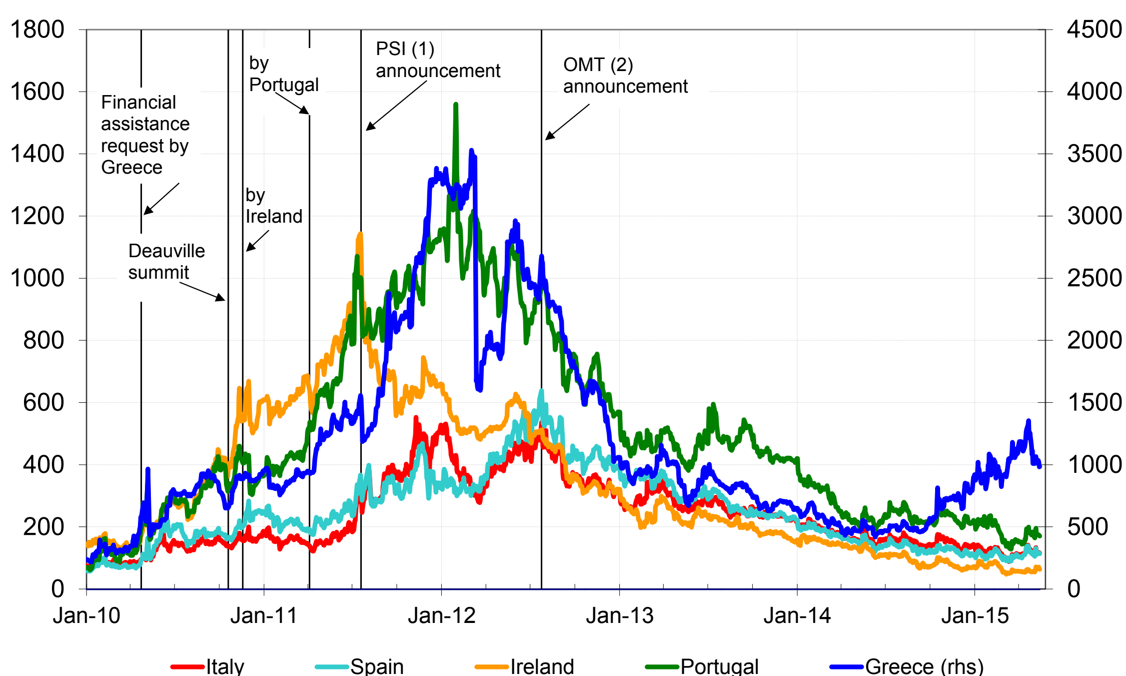
[20] In its ex post evaluation of the 2010 SBA for Greece, the very IMF recognized that the program was "a necessity", given the "considerable dangers for the euro area and the global economy should Greece have been allowed to default" (IMF 2013, p. 32).

Systemic spill-overs in the euro area

The reality of a risk of systemic repercussion has been challenged by some (see, e.g., Mody, 2015, and the references therein). Much controversy followed an agreement between the German Chancellor Merkel and the French President Sarkozy, at a summit in Deauville in October 2010, to the effect that distressed sovereigns who sought official financial assistance should also be required to negotiate a reduction in their debt repayment obligations to private creditors. Risk premia paid by distressed European sovereigns rose in the months after the summit. Steinkamp and Westermann (2014) and Mody (2015), among others, trace the increase to the expansion of official debt rather than to fears of debt restructuring per se (private creditors assumed that they would be 'junior' to the official debt, thus facing a higher risk of an arbitrary and disorderly restructuring). However, risk premia kept rising as the debate on private sector involvement in sovereign debt restructuring continued in the first half of 2011, and after the official announcement in July 2011 that such an involvement would indeed take place in the case of Greece.

Euro area government bonds: yield differentials vs Germany, 10yrs horizon

(daily data; basis points)



(1) Announcement of Private Sector Involvement in the restructuring of Greek sovereign debt.

(2) Announcement of Outright Monetary Transactions (see section 3).

Di Cesare *et al*. (2012) present evidence that, for several countries, risk premia reached levels well above what could be justified on the basis of fundamentals. Among the possible reasons for this, they focus on the perceived risk of a break-up of the euro area. Reducing this perception was the centrepiece of the strategy adopted by European authorities (including the ECB) in response to the crisis (see section 3). Those who deny the risk of systemic repercussions from sovereign crises in the euro area seem to overlook the peculiar institutional nature of the single currency area, which at the time lacked tools and procedures to manage sovereign crises (as noted in section 1) and still lacks today a central fiscal authority.

The systemic clause is now the object of intense scrutiny, as its alleged merits have been questioned by both the Fund (IMF, 2013b and 2014a) and other commentators (Schadler, 2013; Boughton *et al.*, 2014; for different views see Truman, 2015, and Ubide, 2015). One concern is that the clause might have reinforced the expectation of Fund-supported financial packages for systemically relevant countries and weakened private investors' incentive to adequately assess sovereign credit risk for this class of countries in the future. Another concern is that the systemic clause may introduce preferential treatment for a subset of

countries, thereby violating the principle of "uniform treatment" embedded in the Fund's Statutes. Yet another concern is that systemic risks are inherently difficult to gauge and analyse properly, so that the clause may have somewhat lowered the "evidentiary bar" for debt sustainability. Finally, the Fund has argued that the arrangements predicated under the clause were *ex post* ineffective in taming cross-border contagion in the EA, as credit default swaps for other peripheral EMU countries continued to rise afterwards.

None of these criticisms appears well grounded. First, systemic relevance is neither a necessary nor a sufficient condition for exceptional access, in so far as all the remaining EAP criteria must be met; moreover, the possibility to restructure the sovereign debt of a systemically relevant country that meets all the EAP criteria is not ruled out *a priori*. Nor would the systemic clause seem to raise concrete risks of moral hazard at the global level, given the Fund's manifest inability to bail out systemically relevant countries.

Second, the systemic clause was meant to apply to all Fund members that could be viewed as systemically relevant, not just European ones; in this sense, the clause is no more illegitimate than current IMF policies for low-income countries.

Third, while assessing international systemic spill-overs remains difficult, this is not a reason for the Fund to refrain from leveraging its surveillance expertise and delineating how alternative crisis management strategies would affect the severity and nature of these spill-overs.[21] Indeed, transparent and rigorous analyses of spill-over effects are of the essence to operationalize the systemic clause in a credible fashion, and to avoid possible abuses (Committeri and Spadafora, 2013). Moreover, the case of Greece, rather than simply suggesting the risks of lowering the bar for the assessment of debt sustainability, indicates that problems may lie with the capacity to deliver the necessarily enhanced policy adjustment—i.e., the fourth EAP criterion.

Finally, the systemic clause alone could not have been expected to effectively counter contagion within the EA. It is not just a matter of the size of the challenge in financial terms: the problem was deeply rooted in region-specific circumstances (such as incomplete political union and the complexity of European decision-making processes), and the remedy consisted in a massive dose of financial firewalls and area-wide governance reforms (see section 3).

The Fund's staff has recently embarked in discussions about further amending its EAP, with the aim of "avoiding undue delays in debt restructurings" and "better tailoring [its] lending policies to the circumstances of monetary unions" (IMFa, 2013, p. 33). The proposed amendments consist of the following (IMF, 2014a, pp. 11-12 and pp.18-21). First, the systemic clause would be eliminated—in other terms, systemically relevant countries would not receive a special treatment any longer. Second, regarding countries whose debt is sustainable but not "with high probability", IMF lending would be made conditional

[21] Concepts such as systemic risks and international spill-overs are hardly new in the Fund's history, as they echoed many times in discussing financing arrangements that were ultimately approved under the ECC. Although the management of these risks and spill-overs largely falls outside the IMF's mandate (as it continues to have no jurisdiction over either international capital flows or countries' financial sector policies), this has not precluded the establishment of precautionary facilities reserved to countries that, despite their sound fundamentals and policies, could be adversely hit by external spill-overs. As well, in recent years the IMF has engaged in a thorough revision of its surveillance procedures over cross-border policy spill-overs and financial sector risks.

to a pre-emptive and voluntary "re-profiling" of private sector claims vis-à-vis the sovereign debtor—i.e., a relatively short extension of maturities to be determined on a case-by-case basis. Such an extension would purport to ease the indispensable adjustment burden imposed on distressed countries, while avoiding any payment default on the country's debt service obligations. If, however, the Fund received specific and credible assurances of substantive concessional support from other official creditors, any debt restructurings (in the form of a re-profiling or an outright debt reduction) could be avoided. In all other cases (including those where countries' debt is clearly unsustainable), the Fund would refrain from providing financial assistance.

The proposed policy changes go well beyond simply reverting to the EAP rules prevailing before euro area crises. Actually, they move the EAP into uncharted waters. Conditioning IMF loans to a debt re-profiling operation may decrease the flexibility needed to respond to uncertain situations, and create undesired collateral damage via disorderly developments in the financial markets. Per se, the required re-profiling of sovereign liabilities is unlikely to guarantee a more sustainable debt in the medium term; quite the reverse, absent full capital controls, this may encourage creditor runs and precipitate a full-blown insolvency crisis. In contrast, concerns about possible abuses of the systemic clause appear somewhat overstated at this juncture, given that the clause in question has so far been applied very sparingly and wisely by the Fund. More generally, the current policy has allowed addressing a variety of situations of elevated uncertainty without the necessity of any formal amendments, including: (a) the second Greek program—which was approved under the systemic clause but entailed a partial restructuring of the country's debt; and (b) the arrangements with Cyprus (2013) and Ukraine (2015), two relatively small countries for which no systemic clause was invoked.

Finally, the idea of conditioning IMF loans to a fully-concessional support from other official creditors seems more an *ex post* rationalization of the Greek case rather than a lesson learned from a solid body of evidence. This idea sends a crystal clear message: the EA should stop weighing on IMF finances; the check for the next crisis should be entirely paid by them, and the Fund's involvement should be kept to a minimum. Is Europe ready to take up this challenge?

3. Could Europe go alone when the next crisis comes?

During the crisis the EU engaged in far-reaching reforms aiming at increasing the coordination of economic policies and strengthening multilateral surveillance and fiscal rules. The first act in 2010 was the introduction of the so-called "European semester", a common calendar synchronizing the processes of budgetary and economic policy planning in EU countries. This provides member states with an opportunity to discuss a collective strategy for the economic policy of the Union and allows the Commission to give policy guidance before decisions are made at national level.[22]

Then in 2011 a collection of six new laws (five Regulations and one Directive), known as the "six-pack", was agreed. The six-pack introduces a new procedure for macroeconomic surveillance (Macroeconomic Imbalance Procedure, MIP) in order to allow early detection of growing imbalances, such as real estate bubbles, banking crises or falling competitiveness. It also strengthens European fiscal rules by giving

[22] In the same year, in order to enhance the quality of statistical data used for the excessive deficit procedure, Eurostat's audit powers were significantly enhanced (Council Regulation (EU) No 679/2010 of 26 July 2010).

quantitative content to qualitative prescriptions in both the preventive and the corrective arm (the "excessive deficit procedure") of the SGP[23] and by introducing "reverse qualified majority voting" (RQMV) for most sanctions, therefore increasing the likelihood that they are approved.[24]

In 2012 the Treaty on Stability, Coordination and Governance (TSCG) was agreed (its fiscal part is referred to as the "Fiscal Compact").[25] The Treaty stipulates that (a) automatic correction mechanisms should be introduced in national legislation to ensure compliance with European fiscal rules, and (b) national independent institutions should be set up and tasked with monitoring fiscal policies and outturns. The necessary amendments to national legislation have been implemented by EA member states. Finally, in 2013 two regulations were approved (the so called "two-pack") with which EA member states agreed to prepare their budgets according to common standards and a common timeline and to submit drafts for comments to the European Commission.

Parallel to the reform of economic governance, tools for granting financial support to countries in distress were gradually defined and made operational. In May 2010 two temporary facilities were set up: the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). Under the EFSM, the Commission is allowed to borrow up to a total of €60 billion in financial markets on behalf of the Union under an implicit EU budget guarantee and to on-lend the proceeds to the beneficiary Member State. The EFSF is a limited company (shareholders are the EA member states) with the power to issue debt instruments and raise funds needed to provide loans to countries of the EA, with an initial capacity of €255 billion (later increased to €440 billion).

In October 2010, the decision was made to create a permanent rescue facility, the European Stability Mechanism (ESM), as an intergovernmental organization set up by international treaty, with a lending capacity of €500 billion. In July 2013 the ESM replaced the EFSM and the EFSF as the instrument for financing any new interventions in favour of EA countries in difficulty. To date, support programs have been arranged for Greece, Ireland, Portugal, Spain and Cyprus.[26] European countries and institutions have committed more than €350 billion in financial aid, as against the €100 billion provided by the IMF.

Finally, a Banking Union has been established, with a Single Supervisory Mechanism led by the ECB acting in cooperation with national supervisory authorities, a Single Resolution Mechanism and new bail-in rules (EU

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[23] The six pack specifies the definition of "significant deviation" from budgetary medium term objectives (or the adjustment path towards them) in the context of the preventive arm of the SGP. It also defines when a debt ratio above 60 percent of GDP is not diminishing at a satisfactory pace, thereby making it possible to launch an EDP also on the basis of debt level and dynamics (not only on the basis of the deficit level).

[24] RQMV implies that a recommendation or a proposal of the Commission is considered adopted in the Council unless a qualified majority of Member States votes against it.

[25] The Treaty was signed by 25 EU member states (all but the UK and the Czech Republic) and entered into force in January 2013, after the necessary ratification procedure. It is only binding for EA Member States.

[26] In line with the bilateral loans to Greece, the original setup of the EFSF provided for loans to be granted at non-concessional terms so as to avoid large implicit fiscal transfers and contain moral hazard. At the same time, there was recognition that rates cannot be too high, as they could jeopardize the feasibility of the borrowing countries' fiscal adjustment, possibly undermining their commitment to consolidate. More recent loans have been granted with a lower mark-up than the earlier ones. Greece has also been granted a grace period until 2022 on its interest payments.

Bank Recovery and Resolution Directive), and a Single Resolution Fund.[27] The handling of banking crises will involve numerous national and European institutions participating in the context of a Single Resolution Board. Provision is made for recourse to a fund made up of contributions paid in by the banks themselves. Even though the decision-making process appears complex and the pooled resources limited, the compromise reached is a further step towards the completion of the Banking Union. Overall, these are key steps to reduce the potential risks stemming from the sovereign-bank nexus, which was a feature of particular relevance to the euro area crisis. Enhanced comparability of financial information on European banks and a clear framework for the orderly resolution of intermediaries and burden-sharing between shareholder and creditors resolution should reduce the risk that banks may get into financial difficulties and turn to their sovereign for help, thus quickly turning a crisis of banks into a crisis of public finances.

Five years into the sovereign debt crisis, the institutional landscape of the EU and the EA has deeply changed. The European Stability Mechanism is a permanent institution with a clear mandate to provide financial support under strict conditionality.[28] The ESM Treaty details the procedure to be followed for granting support to a member state (art. 13) and the form such support may take, ranging from precautionary credit lines to loans and to purchases of bonds on the primary and on the secondary markets (arts. 14-18). This is a giant leap from the institutional vacuum that had been created by the no bail-out clause in art. 125 of the TFEU.

Taken at its face value, the ESM's financial firepower (€500 billion) may seem limited when measured against the EA's GDP, which exceeds €10 trillion. However, one should be mindful that additional protection is provided by the ECB's Outright Monetary Transactions (OMT)—purchases of sovereign bonds in secondary markets—which are also conditional to the presence of an ESM program and for which no *ex ante* quantitative limit is set.[29]

During the crisis, the European commission and the ECB worked side-by-side with the IMF on the definition and monitoring of programs in five member states of the euro area (Cyprus, Greece, Ireland, Portugal and Spain). Additional experience was gained with the balance of payment assistance programs for Hungary, Latvia and Romania.

The underlying causes that led to critical events in a number of member states over 2010-2014 have also been directly addressed. As discussed above, the preventive arm of multilateral fiscal surveillance has been strengthened, it is now flanked by surveillance over macroeconomic imbalances, and centralized banking

[27] The decision to assign supervisory tasks to the ECB within a Single Supervisory Mechanism (SSM) was taken at the European Council of 29 June 2012. The regulation on the SSM (No 1024/2013, of 15 October 2013) entered into force on 3 November 2013. The regulation on the Single Resolution Mechanism (No 806/2014, of 15 July 2014) entered into force on 19 August 2014. The Bank Recovery and Resolution Directive is No 59/2014 of 15 May 2014. The Single Resolution fund was implemented by regulation 81/2015 of 19 December 2014.

[28] According to art. 3 of the ESM Treaty, its purpose is "to mobilise funding and provide stability support under strict conditionality […] to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States. For this purpose, the ESM shall be entitled to raise funds by issuing financial instruments or by entering into financial or other agreements or arrangements with ESM Members, financial institutions or other third parties".

[29] OMTs are aimed "at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy" (http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html).

supervision has been introduced to reduce the risks arising from heterogeneous supervisory practices in the euro area.

Finally, conditions for a more orderly resolution of a sovereign crisis compared, say, to what happened with the "private sector involvement" in Greece or with the treatment of failed banks in Ireland have also been put in place. As noted in section 2, EA members have started to include CACs in their EA government bond issuances since as early as January 2013. These clauses contemplate effective aggregation mechanisms that are fully consistent with the new standard agreed by the International Capital Markets Association (ICMA) and the Institute of International Finance (IIF). As well, the new bail-in rules set in the EU Bank Recovery and Resolution Directive and the establishment of the Single Resolution Fund (though with the limitations discussed above) have also significantly reduced the expectation of sovereign involvement in the resolution of failed banks.

Today Europe appears less in need of external help in managing possible new sovereign crises. Concerns over the possibility of "political capture" of the European Commission should not be dismissed too easily — especially considering that the role of the ECB in European financial assistance programs may need to be revised too.[30] But they should be weighed against the need for a proof of maturity of the single currency. It remains to be seen whether Mr. Barroso's claim in 2010 that "we have solved this in the European family, in the euro area [… with …] the triggering of the mechanism and the implementation of conditionality […] carried out by the EU institutions" can finally be brought to bear in full.

Some excess rigidity remains in the mechanism governing the provision of financial support to countries in distress. The Treaty establishing the ESM requires unanimity for a number of key decisions, including the provision of "stability support", the definition of policy conditionality and the choice of financial terms and conditions (art. 5.6). This may represent a significant impediment to the timely adoption of measures. An emergency procedure is available "where the Commission and the ECB both conclude that a failure to urgently adopt a decision to grant or implement financial assistance […] would threaten the economic and financial sustainability of the euro area" (art. 4.4). But even under this procedure a qualified majority of 85 percent of the votes cast is required. By way of comparison, financial assistance decisions at the IMF are taken by simple majority.

Other complications may arise, since a continued cooperation between the ESM and the IMF is formally sanctioned in the Treaty establishing the new European rescue fund. The Treaty stipulates that: "The ESM will cooperate very closely with the IMF in providing stability support. The active participation of the IMF will be sought, both at technical and financial level. A euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF" (whereas nr. 8).[31] True, there is no strict obligation on either party to cooperate: the IMF is not a signatory to the

[30] The ESM Treaty calls for the European Commission to act "in liaison with the ECB" in all matters concerning the granting of financial support to a member state (art. 13). However, a recent opinion of the EU Court of Justice Advocate General on the compatibility of ECB's OMT program with the Treaty on the Functioning of the EU may suggest a limitation of the role of the ECB. Specifically the Advocate General argues that "if exceptional circumstances were to arise which were grounds for activating the OMT programme, it would, for that programme to retain its function as a monetary policy measure, be essential for the ECB to detach itself thenceforth from all direct involvement in the monitoring of the financial assistance programme applied to the State concerned" (http://curia.europa.eu/juris/documents.jsf?num=C-62/14).

[31] Furthermore, art. 13 of the Treaty, dealing with the granting of financial support, provides for IMF participation – "wherever possible" – in the assessment of the sustainability of the public debt of the country concerned (13/1), in negotiating a

Treaty or a member of the ESM, and euro area countries are only requested to seek IMF cooperation "wherever possible". Nevertheless, it cannot be taken for granted that a pragmatic interpretation of the Treaty would be sufficient to warrant a way out of this engagement; instead, a renegotiation of the Treaty may be necessary.

4. Concluding remarks

In this paper we have looked at the events that led to the IMF's involvement in the management of sovereign debt crisis in the euro area, discussed how IMF lending policy evolved both before and during the crisis, and analysed the deep reforms of economic governance within the single currency area implemented since 2010.

We have come to the conclusion that: (i) Europe could not have done without the IMF at the time of the Greek crisis for both lack of institutional capacity and concerns over moral hazard; (ii) the introduction of the "systemic clause" in the IMF lending policy did not represent a bending of the rules but the natural response to exceptional circumstances of a framework which has always, necessarily, displayed a degree of flexibility; (iii) deep changes in the euro area institutional landscape should allow its member states to do without the IMF in managing possible new crises in the future, despite some residual excess rigidity in the procedures governing financial support and the possible need for Treaty amendments.

Both the IMF and Europe are left with important issues to be resolved. The explicit recognition of systemic risks in the Fund's lending policy has opened up a wide field of research, which remains largely unaddressed at this juncture. A most relevant problem is finding resources adequate to the task. On the other hand, the single currency remains a "half-built house", a "money without a state" and the problems of being in mid-stream cannot permanently be dealt with by simple institutional engineering.

The Fund's financial firepower can be upgraded through either a substantial increase in its permanent resources (i.e., its quotas), or an enhanced ability to quickly mobilize additional resources on a temporary basis in case of need. As noted by Boughton (2001), expanding IMF quotas has always been a "politically contentious task"[32]. Over the years, quota increases have been typically deliberated in a reactive rather than in a pro-active manner and the financial size of the Fund has shrunk relative to the world economy and to international capital flows. This state of things is only partially explained by obvious political hurdles in quota negotiations or by concerns over moral hazard in the system (the first pillar of the Prague strategy). Determining the "optimal" or "appropriate" financial size of the Fund remains a highly conjectural exercise, which is also crucially influenced by how its shareholders perceive threats to global stability.

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memorandum of understanding detailing the conditionality attached to the financial assistance facility (13/3), and in monitoring compliance with the conditionality attached to the financial assistance facility (13/7). Art. 5 also states that "representatives of institutions or organizations, such as the IMF, may be invited by the Board of Governors to attend meetings as observers on an *ad hoc* basis".

[32] The dogged refusal of the US Congress to ratify the general quota increase (and the related governance reforms) approved in 2010 is a vivid example of the politically sensitive issues attached to IMF quotas. Another example is the decision of other members (notably Canada, Switzerland and Brazil) not to participate in the second wave of bilateral borrowing agreements launched by the IMF in 2012, which in some cases was taken as a form of protest against the euro area (Flaherty 2012).

Other hints can be drawn from the political economy literature, where the Fund is gauged through the lens of a principal-agent framework, and where large countries with heterogeneous preferences (the “principals”) try to exercise control over an agent (the IMF) that maintains wide margins of *de facto* autonomy[33]. In this context, the “principals” may tacitly collude to enforce a “structural deficit” of IMF resources, so as to strengthen their control over at least the most important lending decisions of the Fund—in the same way as central banks try to stabilize, at least in normal times, money market interest rates with the minimum reserve system imposed on banks. A pertinent example of this point is represented by the governance modalities of Fund borrowing—particularly through the New Arrangements to Borrow (NAB), which until recently represented a genuine “club of creditors” with an effective voice on individual Fund arrangements[34].

As is evident, there remains a huge tension between these problems and the need to address systemic emergencies effectively. In recognition of the merits of suitable financial firewalls,[35] the Fund has relentlessly insisted on the need to establish stronger “global financial safety nets” (GFSN), and solicited both (a) a precautionary extension of temporary official borrowing via the NAB and bilateral loans; and (b) more structured forms of cooperation with the central banks of reserve-issuing countries as well as with regional financing arrangements (RFAs). Unfortunately, this invitation has received a rather lukewarm response so far, with the only exception of the European Stability Mechanism.[36]

In our view, the proposed amendments to the Fund’s exceptional access policy are strictly related to this state of affairs. If these amendments were approved, this would sanction an overly prudent and rigid lending policy and a diminished role of the IMF in the global financial system.

On the other hand, EU institutions are now called to walk a thin line between the need to preserve the credibility of the rules that have been agreed upon and the need to apply them wisely, taking duly into account the specific circumstances of each member state and of the euro area as a whole. Early positive signs have come earlier this year with the Communication by the European Commission on flexibility in

[33] See for example Copelovitch (2010). Most of this literature focuses on the conditionality and the distributive consequences of *individual* IMF packages. If anything, this approach would seem to suggest a tendency to *increase* (not freeze) Fund resources, given the “credit union” features of the IMF: in other terms, its major shareholders could pursue their alleged interests more easily by leveraging their own quotas with those of the other members.

[34] In 2009, as a response to the global crisis, the NAB was reformed and expanded to include the participation of some major emerging market countries. In that context, participating countries accepted the Fund’s proposal to allow that NAB resources be used to finance all IMF arrangements, not just specific ones.

[35] These merits have been clearly testified by (a) the positive response of emerging market countries’ spreads to the decision of tripling IMF resources in 2009, and (b) the dramatic narrowing of credit default swaps for peripheral EMU countries after Draghi’s “whatever it takes” speech in July 2012, the ECB’s announcement of Outright Monetary Transactions in September 2012, and the ECB’s decision to activate QE in March 2015.

[36] Central banks plainly refused to upgrade their bilateral swap arrangements into a multilaterally-coordinated framework, reflecting their preference for a “constructive ambiguity” approach to emergency liquidity assistance, as well as their concern about possible political pressures conveyed via the Fund (CGFS-Committee on the Global Financial System, 2011). As discussed in section 3, the ESM envisions IMF involvement in its financial assistance “wherever possible”. As regards non-European RFAs, both the Chiang Mai Initiative Multilateralisation (CMIM, USD240 billion) and the newly established Contingent Reserve Arrangement among the BRICS (CRA, USD100 billion) contemplate a statutory link to IMF loans (so-called “IMF-linked portion”), but the concrete modalities of cooperation in terms of surveillance, lending practices, and program conditionality are yet to be defined in detail and tested in practice. Finally, general support for an extension of Fund borrowing is far from being taken as granted at this juncture.

fiscal rules in the face of adverse macroeconomic circumstances and in consideration of the short term costs of structural reforms.[37]

Similarly, positive signs can be detected in the evolution of the pricing policy of financial assistance granted to member states, from “interest rates will not contain any subsidy element” (at the Spring European Council of 25-26 March 2010, based on an extremely restrictive interpretation of the no bail-out clause) to “the ESM shall aim to fully cover its financing and operating costs and shall include an appropriate margin” (in art. 20 of the ESM Treaty) and all the concessions granted to Greece in 2012 for the second assistance program.[38]

That said, the need for strengthening policy cooperation within the euro area is evident.[39] The main issue remains the need to complement the single currency with a federal budget, a point that was stressed already in the 1970s, during the early discussion of the project.[40] The debate on how to further deepen the economic and monetary union, not only on the fiscal side, is rich. Though additional work is underway,[41] the two main “official” references remain the Commission’s blueprint for “a deep and genuine economic and monetary union” (European Commission, 2012) and the so-called “report by the four presidents” (Van Rompuy *et al.,* 2012). The President of the ECB has noted how “since 2010 the euro area has suffered from fiscal policy being less available and effective, especially compared with other large advanced economies” and that “it may be useful to have a discussion on the overall fiscal stance of the euro area [… which …] is not based on a single budget voted for by a single parliament” (Draghi, 2014). More recently, with a broader reference to economic policy, he has stressed how “we need to move from a system of rules and guidelines for national economic policy making, to a system of further sovereignty sharing within common institutions” (Draghi, 2015).

A fully-fledged fiscal union can only be a long-term project. This does not prevent the adoption of intermediate steps to bring gradually under a common framework individual budgetary items such as unemployment benefits (Brandolini *et al.*, 2014) and pensions (Balassone *et al.,* 2014) which would both provide some extra degree of counter-cyclical stabilization and foster the effective integration of Europe’s labour markets. However, even such intermediate steps require member states to relinquish significant sovereignty, and before this is possible a deeper sense of trust among (citizens of) member states will need to be re-established.

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[37] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf

[38] During 2012, several debt relief measures were granted to Greece by members of the euro area, including: (a) a reduction by 100 basis points of the interest rate on bilateral loans (Greek Loan Facility, GLF) to the 3-month Euribor rate plus a margin of 50 bp; (b) the cancellation of the guarantee commitment fee, amounting to 10 bp of the interest paid by Greece on EFSF loans; (c) an extension of the maturities of bilateral and EFSF loans by 15 years, and a “grace period” of 10 years on EFSF loans; and (d) the commitment by Member States to pass on to Greece an amount equivalent to the income on the SMP portfolio accruing to their national central banks.

[39] Saccomanni (2015) provides an up-to-date discussion of the shortcomings of the European union and of the euro area in this respect.

[40] Among recent contributions, Cottarelli and Guerguil (2014) draw on the experience of 13 federal states to discuss the main issues arising on the path to closer fiscal integration in Europe.

[41] The Euro Summit of 24 October 2014 invited the President of the European Commission “to prepare next steps on better economic governance in the euro area”. In February 2015 an analytical note was presented at an informal European council meeting in Bruxelles (Juncker at al., 2015) “intended to start a discussion process that will feed into a forward-looking report” (p. 1) discussing, inter alia, whether “further risk-sharing in the fiscal realm [is] desirable [and] what would be the preconditions” (p. 8).

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Appendix

The contractual approach to sovereign debt restructuring

After the demise of the SDRM (Sovereign Debt Restructuring Mechanism)—a proposal to entrust an international body with the task of administering the resolution of sovereign debt—work in this field principally redirected towards the promotion of collective action clauses (CACs)[42] in sovereign bonds issued in key international financial markets.[43] This strategy was complemented by the adoption of voluntary codes of conduct by some sovereign issuers and international investors (see Institute of International Finance, Principles for Stable Capital Flows and Fair Debt Restructuring, https://www.iif.com/topics/principles-stable-capital-flows-and-fair-debt-restructuring).

Following Mexico's pioneering move of February 2003, collective action clauses are now routinely included in all sovereign issuances subject to the law of New York. On their side, euro area countries have started to include standardized and identical CACs in their new sovereign bonds with maturity above one year since January 2013 (European Council, 2010 and 2011). Yet, as these clauses are typically introduced on an issue-by-issue basis, the outstanding stock of international sovereign bonds still contains a non-negligible fraction of debt securities without CACs. Moreover, in the last decade many emerging market countries were able to issue government bonds denominated in local currency and subject to domestic law; these bonds are amply traded internationally and normally do not contain any CACs.

Actual experience with CACs is not vast, but seems to confirm their beneficial role in securing creditor participation and avoiding protracted negotiations. True, in the late 1990s sovereign debt had been often restructured successfully even in the absence of CACs (e.g.: Russia, Ukraine, Pakistan, Ecuador) According to Bi *et al*. (2011), this could be explained by the combination of exchange offers that were sufficiently attractive to promote participation with the resort to legal tools of a more coercive nature (such as minimum participation thresholds and "exit consents").[44] However, the very absence of CACs was also a key precondition of the recent (and most prominent) case of litigation between NML Capital and the Republic of Argentina—this episode would have never occurred if CACs had been already in place.[45] And there have been several instances where the actual use of CACs enabled full creditor participation and facilitated the debt restructuring process (Ukraine 2000, Moldova 2002, Uruguay 2003, Belize 2007 and 2013, Seychelles 2010, St. Kitts and Nevis 2012; see IMF, 2013a). In the case of Greece (2012), holdout creditors were able to veto the restructuring of a few bond series with CACs (which did not contain any provisions to aggregate

[42] CACs allow a qualified majority of bondholders to agree on modifying the so-called "reserved matters" of a bond contract (essentially its payment terms), and to make these changes binding on dissenting bondholders (holdouts), who might otherwise veto a restructuring and hold out for preferential treatment.

[43] "Domestic" bonds were not the primary target of these efforts, reflecting the view that sovereign debtors had already effective means to cope with their domestic creditors when a debt reduction was needed.

[44] An "exit consent" is a formal agreement that allows a majority of creditors that hold the bonds tendered in an exchange to "exit" from them and change their non-financial terms in a way that makes these bonds effectively worthless for the minority holdouts. This technique encourages full creditor participation in a bond exchange involving instruments that do not contain CACs.

[45] For more details see the Box "Argentina Litigation in the U.S." and the Annex "Recent History of *Pari Passu* in New York Law-Governed Sovereign Debt" in IMF (2014b).

creditors across multiple issues), but this did not derail the overall restructuring process.[46] Finally, it is worth noting that the issuance of sovereign bonds containing CACs has not been penalized by the market with higher risk premia, as feared by some commentators in the early 2000s (for a review of the empirical literature, see Committeri and Spadafora, 2013, and the references therein).

Mostly in light of experience with Greece and Argentina, the Fund (IMF, 2014b) has proposed to enhance the contractual approach with: (a) stronger mechanisms for aggregating creditor votes across all affected bond series (so-called "single-limb" voting, with an overall threshold for modifying the financial terms of the contracts and for binding dissenting creditors with a blocking majority in a single series);[47] and (b) an amendment of the standard *pari passu* clause included in the bonds' documentation, to explicitly exclude the obligation to pay creditors on a "ratable" basis—thereby bypassing the recent litigation problems encountered by Argentina.

All in all, collective action clauses (augmented with aggregation provisions) represent a potentially cost-effective device for facilitating the restructuring of unsustainable public debt; importantly, they would not pose the politically sensitive constraints on countries' sovereignty attached to statutory approaches such as the SDRM. Their main shortcoming is the considerable time it will take to extend them to the entire stock of debt outstanding. For this reason, in the foreseeable future sovereign debt restructurings will remain an eminently *ad hoc* exercise, relying on a variety of instruments to be combined on a case-by-case basis.

This being said, the ability to manage a sovereign debt restructuring in an orderly fashion does not dissipate the risks of disruption posed by the default of a systemically important country. In the absence of additional pre-conditions (such as stronger capital and liquidity frameworks for financial institutions and the availability of adequate financial firewalls to contain contagion stemming from these linkages at both the national and cross-border levels), no predefined framework for debtor-creditor relations (CACs or even the SDRM) would be sufficient to mitigate the economic costs associated with a sovereign default.

[46] As the Greek debt to be restructured was mostly represented by domestic bonds, the Greek parliament could enact a law to reduce sovereign obligations by fiat; CACs with aggregation provisions were introduced retroactively in the context of a debt exchange.

[47] The single-limb voting proposal goes beyond the approach followed in the euro area model CAC—which contemplates two distinct thresholds (one for aggregating different series and one for individual series). However, the menu of voting options finally accepted by the Fund is broadly compatible with the two-limb voting model adopted by euro area countries. This latter model was agreed reflecting concerns over the accommodation of debtor-creditor equity in the absence of any supervising judicial authority, and having in mind the legal enforceability of this mechanism across the euro area.