



Improving Eurozone Economic Governance

In the framework of the FEPS seminar on
“European Recovery, The Franco-German relationship
and European Integration”

SONY KAPOOR

Managing Director of Re-define

Brussels, 15th September 2010

Any further information can be obtained through FEPS Secretary-General Dr Ernst Stetter at
ernst.stetter@feps-europe.eu

Introduction

Monetary union without a fiscal backup was always a risky venture. Just how risky, has come to light during the ongoing financial crisis. The crisis, which originated primarily in the private financial sector morphed over time into a near-crisis of sovereign debt. This in turn, as the recent attention given to stress tests shows, has threatened to feed back into a second round of a crisis in the banking system.

Sovereigns provide the final backstop for the banking sector and the banking sector in turn is a significant provider of finance to sovereigns. The high degree of interdependence between the financial sector and sovereigns has been reinforced during this crisis. Banking crises often lead to sovereign debt problems and sovereign debt problems will almost inevitably increase the likelihood of a banking collapse.

Any discussion on

- how to manage the Eurozone better or
- how to prevent the recurrence of a crisis of this magnitude

will necessarily need to address the problems observed both in the private financial sector as well as those in the sovereign debt markets. The crisis has importantly highlighted two main lacunae in the governance of the Eurozone. First, that the Eurozone has lacked a workable crisis management framework and second, that policymaking for private as well as public balance sheets was far too complacent in peace time and allowed unsustainable amounts of risk to build up in the first place.

This paper puts forward suggestions on how best to improve Eurozone economic governance so that both peacetime economic management and crisis management are improved. On both of these fronts, there are important lessons that can be learnt from previous episodes of managing crisis in the banking sector as well as from the rich set of proposals that are currently being discussed to discourage excessive risk taking in the financial sector.

This paper

- Suggests a comprehensive crisis management framework for the Eurozone
- Applies lessons from discussions on the prevention and management of banking crises to sovereigns
- Makes suggestions for an improvement of EU economic governance during 'peacetime'
- Offers a constructive critique of various Eurozone governance reform proposals already on the table

Building a Comprehensive Crisis Management Framework

Crisis management is firstly and foremost about minimising the likelihood of occurrence by putting in place effective ex ante risk reducing policies – **Crisis prevention**.

No matter how good such policies look on paper, economic externalities, and endogenous developments in financial markets or stochastic factors can dislocate even the best plans and trigger potentially destabilizing disturbances in the financial markets. These often take the form of liquidity black holes and/or asset prices collapses and/or a collapse in confidence. The challenge at this stage is to contain the crisis, limit damage, stop widespread contagion and restore confidence – **Crisis mitigation**.

Even with the best of efforts to contain a crisis, sometimes it will deepen and spread. Under such a scenario, mitigation gives way to rescue and making a fresh start – **Crisis resolution**.

In fire-fighting terms, prevention comes from having a strong fire code, responsible behaviour and taking appropriate precautions. The distinction between crisis mitigation and resolution is somewhat arbitrary but nonetheless critical. Crisis mitigation is about putting out an incipient fire and stopping it from spreading. It will involve the use of smoke alarms, hand-held fire extinguishers, fire blankets and fire doors. Mitigating a crisis or a fire successfully, often entails little cost or damage and going back to the ‘normal state of affairs’ is usually easy.

If the crisis or fire is too large or the mitigation tools are inadequate, the problems deepen and spread and cause widespread damage. This is where the big boys, the fire brigade or in the case of financial markets, recapitalizations or bankruptcy are needed to help limit damage and make a fresh start. The degree of collateral damage and the possibility of a healthy fresh start depend on the quality of crisis resolution and rescue measures, or in the case of fire, on the quality and response time of fire brigades and the existence of appropriate insurance policies.

Thus, an effective crisis management framework for the Eurozone will focus on putting crisis prevention, crisis mitigation and crisis resolution tools in place for both the financial sector and sovereigns. In the next section, we discuss some of the main features that such a framework will entail, list what new policy measures have been put on the table and make suggestions on how to improve and strengthen the nascent crisis management apparatus that will need to be a central part of any reform of EU economic governance.

Our underlying assumption is that a parallel crisis management framework for the financial sector is already being put in place (see “The Financial Crisis, Causes & Cures”, Re-Define Book, 2010) so we focus on crisis management for sovereigns.

‘Peace Time’ Economic Management and Crisis Prevention

A crisis prevention framework will focus on stopping the build up of excessive risks in the financial system as well as on limiting fiscal and macroeconomic imbalances. This is closely entwined with better economic management during normal economic times. This is best achieved through a combination of:

- prudent principles and targets
- better euro area level co-ordination
- that are owned by MS and
- the availability and use of appropriate policy tools
- in a countercyclical manner so as to minimise the build-up of risks.

However, not all sets of monetary, fiscal, regulatory, competitiveness and structural policies are available to euro area governments. Even when policy space was available, it was not always used appropriately. In particular, euro area governments face some particular challenges:

- Monetary policy is conducted by the ECB and national governments have no room for adjusting this to better fit local economic conditions
- The Stability and Growth Pact (SGP) has limited room for manoeuvre of fiscal policy (if not very effectively)
- Regulatory policy for the financial sector was lax and allowed far too much risks to build up in euro area financial systems
- Competitiveness has been ignored because the current account imbalances that allowed divergences in competitiveness to be sustained were ignored both by the SGP and by the financial regulators, and
- The political economy of structural policies is such that it is very hard to change them.

This meant that the divergent growth and inflation rates in the euro area led to sustained negative real interest rates in countries such as Ireland, Spain and Greece which brought about asset bubbles. These bubbles were financed, in part, by financial institutions in low inflation slow growth economies such as France and Germany. When the financial crisis hit, both sets of countries were vulnerable and as public balance sheets absorbed financial system risk, markets reassessed the credit worthiness of countries within the euro area.

The fiscal balances that the SGP observed missed the build-up of these risks altogether and by the time Spain saw its fiscal account turn from being in surplus to having a 10% deficit, it was too late for crisis prevention measures to have any effect and the EU was forced to turn to crisis mitigation. This has been one of the drivers of efforts at the EU level to improve the crisis prevention framework in the euro area. Several policy measures have been suggested, some by EU institutions, others by academics and think tanks. We discuss these briefly and make our own suggestions for improvements.

EU Measures

The main measures already agreed (at least in principle) under this category are:

- Improving the quality, scope and timeliness of economic information in order to facilitate better co-ordination at the EU level and the introduction of the European Semester
- Strengthening the sanctions under the SGP and focusing not just on the values of the deficit and debt stock parameters but also their rate of change and the scope for early intervention before limits are breached
- Strengthening the EU macroeconomic framework which is currently very weak
- A renewed call to focus on policies for structural reform and measures to restore competitiveness in euro area countries that are lagging behind

Other commentators have suggested a number of other policy measures such as

- Introducing National Fiscal Councils
- Taxing debt levels in excess of a ceiling
- Stronger sanctions in terms of withdrawing access to the ECB and to the EFSF
- SGP implementation through an independent body at the EC level
- The issuance of Eurobonds in various forms.

Analysis

The biggest indictment of the SGP in its current form was that Spain and Ireland, which did not violate the SGP and ran surpluses, were amongst the countries most vulnerable to the sovereign debt crisis. The SGP, with its exclusive focus on fiscal balances, completely ignored private sector imbalances and the related current account imbalances. So extending the mandate of the SGP to monitor risk building and excessive private sector, financial sector and current account imbalances is the sensible thing to do.

However, while fiscal policy might, at least for the most part, be under government control, other economic outcomes are the collective results of millions of individual decisions by economic actors so governments can at best have only a limited influence on them. The EU and its constituent states are not command-economies, so there are serious limits to what even willing governments are able to accomplish in the name of co-ordination or reduction of imbalances.

So, while the European semester, peer review of budgets and enhanced efforts at co-ordination are welcome steps there should be an explicit recognition at the outset that these steps will not eliminate imbalances and divergences but can only mitigate them somewhat.

Since most of the domestically originating observed financial instability in the EU can be traced back to intra-euro area divergences, there is an urgent need to also devise additional policy instruments that give governments more policy space to mitigate these.

Negative real interest rates were the major drivers of housing bubbles in countries such as Spain and Ireland and one of the causes of over-indebtedness in Greece. In the absence of any monetary policy space to manage significant real interest rate divergences, the main options available to euro area countries are to use fiscal or structural policies as the main adjustment tools.

These might help at the margin but there are strict limits to what can be achieved. The nearly 10% fiscal surpluses needed to counter the negative real interest rates in Spain are politically impossible to achieve in any country. Wage restraints and deep structural changes in growing economies are also almost equally hard to achieve.

The problems with other suggested proposals such as National Fiscal Councils, the European Monetary Fund, the Blue Bond proposal etc are that they all focus on the symptoms (fiscal accounts) rather than the fundamental causes, such as: limits to government fiat, stochastic economic shocks and the lack of sufficient policy space to run a countercyclical policy.

The implicit assumption in many of these proposals is that it was a lack of willingness on the parts of euro area governments, rather than a lack of ability or policy options, that led us into this crisis. This assumption is seriously flawed.

Policy Recommendations

In order to further strengthen the crisis prevention framework in the euro area, we propose:

- **Introducing differentiated reserve requirements run by national central banks:** Because the spread of real interest rates is a continuing source of divergences and imbalances, allowing national central banks to require domestic banking operations to hold different amounts of unremunerated (zero interest) reserves against liabilities can help adjust real interest rates so they are more suitable for the national economic conditions. This will help reduce the build up of excessive risks and imbal-

ances. Currently the ECB levies uniform reserve requirements that it pays interest on. This will need to change. If this is legally complicated, a similar end-result can be achieved by using asset based reserves.

- **Using a countercyclical prudential and regulatory policy :** Member States have at their disposal a number of instruments such as asset based reserve requirements, loan to value ratios, financial transaction taxes, loan loss reverse targets and bank levies that can be used counter cyclically in conjunction with or as a substitute for the liability based reserves we have suggested above.
- **Using GDP Linked Bonds:** Member states could start issuing GDP linked bonds where the interest is linked to the GDP growth rate so debt service payments increase in boom times when a country can most afford them and fall in a slowdown giving the country some breathing space and thus acting to stop a temporary economic dip from turning into a recession. These bonds hardwire an automatic counter-cyclical fiscal policy which is stabilizing for the economy. Market surveys indicate that there is a growing appetite for such bonds.
- **Stress testing budgets and contingency budget plans:** Member states should be obliged to stress test their budgets against a number of scenarios that are decided by the European Commission, publish the results and take them into account to introduce more counter cyclicity in fiscal policy. In addition to this, MS should be made to publish contingency plans for fiscal policy that detail what a MS would do in the event of facing fiscal problems that would need to include 1) where it would obtain temporary liquidity from – how much and at what rate 2) which taxes it would raise 3) which expenditures would it cut 4) how it would deal with a solvency problem.
- **Lengthening the maturity profile of country debt:** The Commission should introduce minimum targets on the average maturity profile of a country's debt since, as we saw in the present crisis, MS such as the UK that had a longer maturity profile on their debt found it easier to tide over temporary dislocations in sovereign debt markets compared to MS with shorter maturity profiles who faced the prospect of rolling over large fractions of their debt under stressed market conditions.

Stemming Panic or Crisis Mitigation

Crisis mitigation is all about nipping incipient problems in the financial sector and the sovereign debt markets in the bud. Crisis mitigation comes into play at the first hint of financial market dislocation.

Since market expectations feed back into prices, which affect fundamentals as well as the future evolution of fundamentals, these expectations can become self-fulfilling. Contagion can come about as low confidence feeds back into expectations and afflicts other parts of the market portfolio. So a circuit breaker mechanism that can halt this feedback cycle should be at the core of crisis mitigation.

In fact, the main focus of new policies and measures in the euro area has been on crisis mitigation, where a number of new measures have already been introduced.

EU Measures

Facility Name	Legal Entity	Institution	Form of Support	Amount	Scope
ESFM	Private Entity	EC	Loan or Guarantee	EUR 60 billion	All MS
EFSF	MoU	Eurofin	Loan or Guarantee	EUR 440 billion	Euro MS
EBoP	EC	EC	Loan or Guarantee	EUR 60 billion	Non Euro MS
Macro	EC	EC			Non MS
ECB Bond Purchase	ECB	ECB	Market Support	EUR 60 billion?	Euro MS
Greek Rescue	IMF/ EU MS Bilateral	IMF		EUR 110 billion	Greece

For sovereigns, the measures put in place include 1) the rescue package for Greece 2) the EFSM 3) the EFSF 4) ECB measures such as relaxing collateral criteria and a bond purchase program

Analysis

The biggest crisis mitigation measures that have been put in place are the set up of the European Financial Stability Fund and the European Financial Stability Mechanism. The biggest problem with this set up is that it has been sold as a crisis resolution measure whereas it is at best only a crisis mitigation measure. In other words, it provides only liquidity support, no solvency support. Below we provide a critical analysis of the EFSF/EFSM.

- The EFSF/EFSM is designed primarily as liquidity support tool but has been sold as a 'permanent' solution to the Greek crisis. Tackling a liquidity problem with a liquidity management tool solves it but tackling a solvency problem with this would make it

worse and transfer the burden of adjustment from the private sector and international governments to euro area governments which would be politically poisonous

- The one month time period for action from request to issue can be too long in the midst of a crisis.
- The two stage process of the EFSF/EFSM issuing bonds and then giving the MS government a loan is needlessly complicated and expensive
- Too small to have any real impact especially if any of the larger MS gets into trouble. They can just about mitigate rollover risk for say a month, but then again, it might be much more sensible to issue guarantees instead of bonds
- The cost of funds provided (around 5%) is too high. A 5% interest burden would be very difficult for a country such as Greece to bear given its fragile fiscal situation
- The MS have decided against going for a preferred creditor status which exposes them to much higher levels of credit risk
- Because of the current structure (where the MS getting EFSF support no longer stands behind it) the size of the fund would diminish exactly when the demand for it would grow
- If there are losses inflicted on other Member States, this could potentially be in violation of the spirit, if not the letter of the Treaty and such losses may also harden political opposition to 'ever closer union' and may exacerbate MS tensions
- It is a network of bilateral loan agreements that make it possible for MS to pull out
- The issuance of bonds by the EFSF might have a crowding out effect on MS bonds

Policy Recommendations

While the EFSM/EFSF design is far from perfect, it can provide the basis for a good crisis mitigation tool for the euro area, particularly if policy suggestions for improving the set up are taken on board. Some of these are

- **A formalization of liquidity provision for sovereigns:** Because the IMF, the traditional provider of liquidity support for crisis mitigation is too small for most large euro area economies, the EU needs an additional vehicle to supplement the IMF's funds. We recommend that the EFSF should be made permanent to serve this purpose and its present minimum institutional structure is ideal for proving liquidity to euro area members on the back of an IMF program. The EFSM/EFSF should explicitly be only a liquidity support vehicle with clear safeguards against credit losses.

- **Preferred creditor status for the EFSF funding lines:** These safeguards can take the form of a preferred creditor status equivalent to the formalized US debtor in possession financing¹ for working capital under the Chapter 11 bankruptcy framework or the less formal preferred creditor status conferred on multilaterals such as the IMF and the World Bank. EU Members States should formally institute changes into their domestic law so the EFSF or EFSM are treated as de jure preferred creditor at par with the similar status that multilateral organizations such as the IMF enjoy.
- **Reduce the rate of interest charged:** Since by definition the EFSF will provide support to MS in trouble, the penalty interest rate charge seems misplaced. Though a similar penalty is sometimes levied on the provision of liquidity support by central banks to the private sector, the situation with sovereign states is different enough not to justify a similar treatment. The IMF typically (as in the case of Greece) provides temporary support at a lower cost of funds. So the EFSF should provide funds at cost or at the rate at which the IMF is lending to the MS in question. A 5% interest rate in the case of Greece would simply worsen its finances.
- **The EFSM/EFSF should provide ‘working capital’ for crisis resolution:** As will be discussed in the next section, crisis mitigation measures are not always enough. This means that MS would sometimes need to restructure their debts. They will temporarily lose market access during this process but will still need access to funds. This is where a liquidity support facility such as the EFSF can continue to be useful by providing such funds but only under a clear legal guarantee for being first in line to get repaid should the crisis resolution process go awry.
- **The EFSM/EFSF should provide guarantees not loans (see discussion below):** We strongly believe that there are several advantages to the EFSM/EFSF providing bond guarantees rather than loans. A three to five year guaranteed bond issue program should provide enough time to deal with both liquidity and solvency problems that any MS faced. While the "guarantee over loan" change does not address the problem posed by the "no bailout clause" per se, it does avoid duplication and excessive transaction costs that are associated with the process of first issuing EFSF bonds and then making loans to MS.

The second big advantage of a guarantee mechanism is that it is much quicker to use so in the event of a liquidity emergency, guarantees can be issued for ‘new bond issuance’ more or less instantaneously rather than having to wait a month which the current suggested framework of EFSF issuance/MS loans would imply.

The third big advantage of a guarantee scheme is that it can help leverage a limited amount of funds. Looking at the model that MBIA and AMBAC, two municipal bond insurers in the US

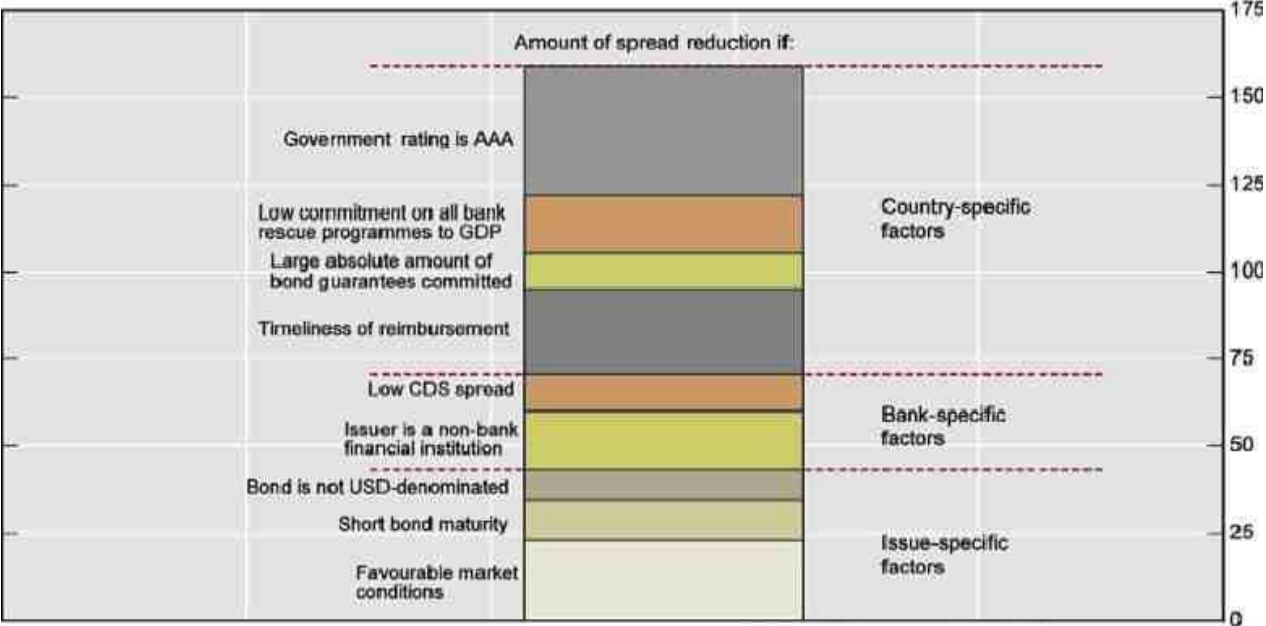
¹ http://en.wikipedia.org/wiki/Debtor-in-possession_financing

used before the financial crisis hit, it is clear that the EUR 60 billion EFSM could for example easily support a bond guarantee program between EUR 200 billion and EUR 300 billion in size with the EFSF capable of supporting a proportionately larger guarantee program.

The alternative, if a decision not to use leverage is taken, would still be to use the EFSF/EFSM to issue euro to euro guarantees for MS bonds rather than use outright bond issuance since it would reduce the double counting of outstanding debt for euro area MS and the market consistently under prices guarantees. This would mean that the debt statistics of euro area MS as a whole would look more favourable on paper and it is likely that the overall interest costs to euro area MS would be lower.

More than EUR 600 billion of bonds were successfully issued by EU banks under Member State guarantees, and these were very effective in stemming the crisis. This concept should be translated to sovereign bonds.

Breakdown of factors influencing the costs of EU guaranteed bank bonds



Source: "Government guarantees on bank funding: Should we extend them into 2010 despite improved bank profitability and the schemes' distortionary effects?" Vox EU column by Aviram Levy and Fabio Panetta, 2009

As is obvious from the graph, the most important determinant of the cost of issuing guaranteed bonds is the strength of the guarantee with the nature of the issuing entity and liquidity of the bond issue being far less important. So the costs of sovereign bonds issued under a EFSF/EFSM guarantee would primarily reflect the underlying strength of the funds and the degree of support members states have provided to them. Here a preferred creditor status would further reduce the costs of guaranteed bonds. Banks were charged roughly 0.5% for guarantees which is much lower than the implicit charge being levied on Greece. We suggest that this charge be used as a benchmark for guaranteeing sovereign bonds.

Making a Fresh Start or Crisis resolution

Crisis resolution measures are mostly about restructuring debt and defining the burden of losses, which in the case of a firm involve 1) winding up or 2) declaring bankruptcy or receiving capital injections. For sovereign states these involve the restructuring of debt liabilities, with or without a formal default.

There has been little progress on instituting crisis resolution measures in the EU so far. Work is in progress on making provisions for a predictable and fast mechanism for resolving financial institutions but crisis resolution work for sovereign debt problems is not even formally on the agenda of policy makers.

EU Measures

EU leaders seem to have decided to put their heads in the sand and hope that the Greek storm is temporary and will blow away. While a number of steps, as discussed in the previous section, have been taken to present liquidity support to Greece, none of them account for the possibility that the Greek sovereign debt situation is simply unsustainable. With debt levels expected to stabilize around 150% GDP, a sharp downward revision to the GDP, increasing interest rates payable and the bulk of interest payments being made to Greek bondholders outside the country, it is unlikely that Greece will be able to repay its debts on existing terms.

Even if one suspends disbelief for a minute and assumes that Greece will be able to service its debts, it remains very difficult to justify why the burden should be shouldered exclusively by Greek public finances and why at least some of the burden should not fall on the private sector owners of Greek bonds. Bleeding a patient to cure him did not work in the middle ages. There is no reason why it would work now.

(There are some who say that this is the only way Greece will make the reforms that are strictly necessary for its long term vitality. That might be so. But the collateral damage being inflicted on several poorer segments of the Greek society is hard to justify. Surely there is a less round-about way of bringing this about.)

Other commentators have made suggestions for putting in place debt resolution measures for the euro area in general and Greece in particular. These have in most cases involved suggestions for setting up a European Monetary Fund or a European Debt Mechanism. There have also been additional suggestions for putting in place collective action clauses (see contribution in this compilation). However, for reasons elaborated in the next section, we do not find these suggestions to be wholly convincing though there are important aspects that can prove useful in the design of a more comprehensive crisis resolution mechanism.

Policy Analysis

The EU's actions on insisting that Greece does not have a solvency problem are understandable in the context that policy makers did not want to spook the markets into a panic. However, these are ultimately self defeating and while the case for ignoring solvency issues might have been stronger in May, the sooner these are acknowledged and dealt with the better it is for all actors involved – the financial markets, Greece and the other euro area MS. Market panic has subsided for the time being and efforts should be made to refer Greece from crisis mitigation to crisis resolution treatment within the 2010 calendar year.

By refusing to acknowledge the depth of Greece's problems upfront, the EU has boxed itself into a serious corner. The longer we wait to recognize that Greece has a solvency issue, not just a liquidity problem, the bigger the burden of any eventual adjustment will need to be borne by the public sector in the EU as an ever increasing proportion of outstanding Greek debt will be directly or indirectly owed to fellow Member States. Such fiscal burden sharing would not only be politically poisonous but will also be against the spirit, if not the letter of the Treaty.

That is why Greek debt needs to be restructured, and done as quickly as possible, to enable the bulk of the burden to be shared between the Greek public sector on the one hand and the largely private sector holders of Greek debt inside and outside the EU on the other. This is primarily an issue of burden sharing between these two constituencies and should have been explicitly recognized to be so.

An increasing number of commentators have been calling for the restricting of Greek debts. There have been proposals to set up a European Monetary Fund (EMF) or a European Debt Mechanism (EDM), driven primarily by recognition to put in place a framework that would allow for sovereign bankruptcy. However, there are already far too many institutions in the EU and the economic governance structure is already far too fragmented, so the establishment of yet another institution should be avoided to the extent possible.

Moreover, foreign governments hold more than \$1 trillion of euro area government debt and would be highly uncomfortable with any EU based institution being able to assign haircuts on holdings of euro area bonds due to potential for conflict of interest. That is why any institutional structure that deals with euro area state insolvency or debt restructuring has to be international and independent from the EU.

The IMF's Sovereign Debt Restructuring Mechanism failed to win widespread support partly because it was seen to be too close to the public sector by private bond holders, and in addition it was seen as potentially conflicted since the IMF too would have exposure to sovereigns whose debts it would help restructure. The right lesson from that is again that the EU cannot depend on an EU institution for restructuring as this would not be seen to be fair by the private sector, which is expected to bear a large part of the burden of any euro area government debt restructuring.

Because both foreign governments and the private sector will bear costs of the haircuts, it is essential to have an institution that would be acceptable to them and which would be seen to be independent of excessive government influence in general and the EU influence in particular. That is why we are strongly in favour of an international mechanism for debt resolution not a European one.

Policy Recommendations

Messy debt restructuring involves significant economic pain both for creditors and debtors, and inflicts large deadweight losses. That is why it would be much better to put in place a predictable and independent sovereign debt resolution mechanism ex ante so that this can play a disciplining role in crisis prevention as well and enable a more efficient and fairer burden sharing.

This is the ONLY way to deal with sovereign solvency problems of the kind faced by Greece, especially as long as the no bailout clause exists and prevents other countries from picking up the tab. This in any case would be dangerous under the current political climate, when resentment against Greece in other MS is at an all time high.

The (direct) burden sharing has to be between the public and the private sector even if this might mean that other EU governments would then face a fiscal burden in order to recapitalize their private financial sector. This would be disciplining, reduce moral hazard, give these EU governments the opportunity to assert more control on their financial institutions including by changing management and it would be technically compatible with the no bailout clause in the EU treaty.

While some discussions have suggested putting in place pan-EU debt restricting mechanism, we believe that it would be strange, perhaps even irresponsible, to put in place a mechanism that applies to the EU alone, especially when poor developing countries have been (and will be again) in far greater fiscal trouble. Under the current fiscal scenarios, it is not just poor developing countries but several other rich countries such as Iceland that are in much worse shape than most euro area countries. Plus, it risks sending negative signals to the market that it is only euro area countries that can default.

Countries in the developing world are much more likely to need restructuring of their debts to other governments, multilateral organizations and the private sector. It would be a missed opportunity and go against the principles of coherence with development policy that are part of EU policy if the sovereign debt restricting mechanism the EU supports will not be open to developing countries. This is the third reason for putting in place an international rather than an EU specific mechanism.

The international environment has changed from 2002 and the IMF might be more acceptable this time round. Failing this, the BIS may be another interesting option. Or an independ-

ent arbitration panel or legal mechanism set up under the aegis of the UN with international statutory authority.

The first best choice is for the EU to revive discussions on an international sovereign debt restructuring mechanism. The IMF's proposed SDRM, the US Chapter 9 model, Paris and London club restructurings, Brady bond restructurings and several other voluntary restructurings and defaults offer a series of instructive lessons on the best design for such an international mechanism.

An International Debt Resolution Mechanism:

- should be based on principles of burden sharing contained in the chapter 9 municipal bankruptcy code of the United States
- extensively use GDP linked bonds and Eurobonds as exit instruments
- operate quickly targeting the timeline for a sovereign bankruptcy of less than 6 months
- make provision for adequate debtor in possession financing
- use an independent panel of experts who are supported by a dedicated secretariat
- address both loans and bonds
- cover liabilities owed to both private and public entities and
- operate under the aegis of a respected international body with a statutory status

References

A crisis management framework for the EU banking sector, Sony Kapoor, Re-Define (forthcoming, October 2010)

The Financial Crisis - Causes and Cures, Sony Kapoor, Re-Define Book (July 2010), Available for download at www.re-define.org

Tackling Sovereign Debt Systematically, Anna Gibson and Sony Kapoor, Re-Define (September, 2010)

Completing the Eurozone rescue: What more needs to be done, VOX EU Book (June 2010), Available for Download at www.voxeu.org

Euro Area Governance – Ideas for Crisis Management Reform, European Parliament Study Compilation, 2010, Available on the European Parliament website